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DIRECT TAXATION AND TERRITORIALITY: ALLOCATION OF TAXING POWERS AND TAXATION OF NON-RESIDENTS IN THE EU

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INTRODUCTION

"I am not happy with the fact that EU tax policy is increasingly being made as a result of Court decisions rather than as a result of coordinated policy actions of Member States. I am convinced that the recent developments in this area could lead to a situation where it will become almost impossible for Member States to protect their tax bases at national level"
(Commissioner Kovács' speech on "The Future of Taxation", London, 2007[1])

The present work has, as its principal aim, the analysis of the possible implications, within the set of rules, provisions and principles that is commonly known as "European tax law", of the principle of fiscal territoriality, especially in the design of a hypothetical theory of allocation of (direct) taxation powers amongst EU Member States with a scope extended to the entire Internal Market. It goes without saying that the field which is most affected by such a topic is the taxation of items of income which are characterised by a "foreign" element, that is to say income of a transnational nature or income accrued by non-resident subjects. The research will mainly focus on that second aspect.

[1] Commissioner Kovács, "The Future of Taxation", speech given on 8 December 2007 in London, available at: http://ec.europa.eu/taxation_customs/resources/documents/common/about/speeches/51201tdi.pdf.
[2] Bethlehem, D., *The end of geography: the changing nature of the international system and the challenge to international*

In other words, what the present work ultimately aims at achieving is considering a possible interpretation of "territoriality" which can fit "the Internal Market territory" through the lens of European Union law. The result could be useful in order to transpose the concept of "territoriality" from its more "traditional" interpretation given from the perspective of international law and/or domestic law to a more authentically European interpretation and application. In fact, as it will be shown in the course of the research (especially in its second chapter), there is still a great deal of uncertainty on the proper definition of "territoriality" in the context of European Union law and on its relevance in the dialectical relationship between domestic tax rules and EU primary and secondary law, especially through the words of the Court of Justice of the European Union.

Therefore, one of the questions to which the present work will try to provide an answer is whether or not (and, if so, how) it is possible to transpose the concept of territoriality as developed by domestic and international law in the field of European Union (tax) law, in an attempt to reach a description of a "transnational territoriality" (the expression seems like an oxymoron) which would be suitable to cover the entire territory of the Internal Market.

There is a clearly evident conflict, and some say incompatibility, between the sovereignty and the fiscal jurisdiction of the Member States as traditionally developed at international level and according to general international law (and as described in the first chapter of the research) and the European Union perspective, aiming at the establishment of an authentic Internal Market. The (still considerably strong) territorial element of each Member State's taxing power can, in other words, constitute a significant obstacle to the fullest possible integration of the European Union and its Market.

Bethlehem has provocatively defined present times as the era of the "end of geography"[2], i.e. as times that supposedly force states to move beyond their traditional notions of international law, sovereignty, jurisdiction and territory. In a context characterised by the globalisation of the economic system, trade and financial flows, some states have, therefore, been criticised for their supposed extraterritorial exercise of jurisdiction, especially in the field of tax law. In other words, the allocation of taxing powers amongst states, and, in particular, between the state of residence of the taxpayer and the state of source of the income on which tax is levied, is challenged, if not entirely eroded, by globalisation and, especially, by the effects played by phenomena such as electronic commerce.

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[2] Bethlehem, D., *The end of geography: the changing nature of the international system and the challenge to international law*, in Journal of International Law, 2014, 1, 9.

It is somehow predictable to state that globalisation, in its widest meaning, has led legal and economic scholars to re-discuss all existing theories on the basic principles of the tax systems of all industrialised countries. This is particularly true with regards to worldwide income tax systems. In other words, with the economic and technological advances that followed World War II, the need for states to rationally regulate cross-border activities and transactions, which, in the meantime, grew in number and in value, was place at the centre of the debate. However, all current regimes are still based on traditional principles of tax systems, such as worldwide taxation, thus leading, *inter alia*, to international double taxation which naturally hinders cross-border trades and compels states to enter into bilateral convention in order to prevent such negative effects.

The traditional view of the state as a political and social organisation condensed within the borders of a territory is certainly out-dated, at least from an economic and practical point of view. The conventional concept of "borders" clashes with the new needs and mechanisms of the market, as an a-territorial place where supply and demand meet on a global level. With inevitable consequences for the sovereignty of the states, which need to redesign their powers and the ways in which they enforce them. In this context, it has even been stated that the logic of negotiation, which is typical of the economic world, would seem to have replaced all merely juridical logics[3].

This is one of the reasons why a juridical analysis of the principle of territoriality (in both its theoretical elaboration and practical implementation), traditionally used by countries to define the extension of the scope of their taxing powers and to allocate tax revenue amongst them (in the international context as far as cross-border items of income are concerned) can be useful to identify possible solutions to the problems posed to the integration of the EU Internal Market by unilateral decisions adopted by Member States possibly through "extraterritorial" exercises of their taxing powers.

The first chapter of the research will, therefore, focus on the "traditional" view of the concept of territoriality in both international law and domestic tax law, aiming at identifying the main traits of the evolution of the concept in these fields, especially as an expression of the countries' (fiscal) sovereignty and of the ways in which countries traditionally choose to allocate their taxing powers amongst them. Specific attention will be paid to the dialectical relationship between the two "traditional" fiscal models used

[3] The origin of the process of erosion of state sovereignty may be identified with the creation of the League of Nations, whose member states renounced their "right to war" and adhered to the principles of international conventions on human rights. More recently, a further limitation to state sovereignty has been the result of the establishment of the European Union, with the transfer of some functions and competences (e.g. market rules, competition, state aids, etc.) from the Member States to the EU institutions. Ferrarese, M.R., *Mercati e globalizzazione. Gli incerti cammini del diritto*, in *Problemi della produzione e dell'attuale normativa*, University of Bologna, Murst Research, 1997, 8.

by countries and their implications, i.e. worldwide taxation and "purely territorial" taxation (source taxation). In that context, the main question will be whether or not is possible to consider territoriality as an actual binding principle for states (and on which grounds).

The following steps will be constituted by the analysis, in the second and third chapters of the research, of the most significant case law of the Court of Justice of the European Union on the point and of the statutory provisions of European Union law in the field of (corporate) direct taxation, in order to understand the relevance and meaning of a hypothetical "territoriality principle" for the purposes of European Union law, verifying whether and how the domestic and international elaboration of the concept can be transposed in the European Union context.

This will serve as a way to define a possible overall theory for the allocation of taxing powers across the entire Internal Market, with a territorial dimension actually and authentically reflecting the main true purpose of the European Union: the attainment of a fully integrated Internal Market from the point of view of taxation as well.

The financial and economic crisis of 2008 has, in fact, imposed some further and new consideration (and maybe re-thinking) on the age-old question of what is and what should be the role of the Union with regards to direct taxation, especially in light of the monetary and budgetary issues Member States have faced in the last eight years. Specifically, the question has arisen whether a deepening of the monetary Union with the Euro-zone should require a limitation of the national sovereignty in fiscal matters and, if it is the case, how this limitation should be implemented. Some scholars have even reached the conclusion that the defence of the common currency can only be effective with the implementation of a supranational authority to which the necessary fiscal and budgetary decisions should be handed over. Prof. Vanistendael, for instance, has supported the necessary transfer by national governments of a substantial part of their national sovereignty to a central authority being competent to make vital national fiscal and budgetary decisions, thus enacting a kind of "temporary federalism in times of crisis"[4].

Nonetheless, and notwithstanding some recent interventions on the part of the EU

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[4] Vanistendael F., *The crisis: a window of necessity for EU taxation*, in European Taxation, 2010, 9. Specifically, Prof. Vanistendael suggests the creation of a new arrangement either by using the existing procedure of enhanced cooperation enshrined in Article 20 TEU or by setting up a new treaty between the Member State of the Euro-zone providing for a transfer of fiscal decisions in times of crisis to a supranational institution. *Contra*, see, for instance, Peeters, B., *Tax sovereignty of EU Member States in view of the global financial and economic crisis*, in EC Tax Review, 2010, 6, 236, which highlights the problem that such a solution could pose to the political and democratic accountability of such a hypothetical authority, advocating the less radical alternative of Euro-zone Member State preventatively endorsing a crisis package of fiscal measures through the existing procedure of enhanced cooperation.

lawmaker (particularly, the so-called "Anti-Tax Avoidance Directive", also covering topics such as exit taxation and Controlled Foreign Company regimes), the field of direct taxation is still largely left to the decisions of the Member States' governments, as the compared analysis of the main traits of the tax system of three "exemplary" EU countries that will be conducted in the fourth chapter of the research will show, with problems such as cross-border loss relief (especially for corporations) still not having found an authentic and clear EU-wide solution.

The substantial lack of coordinated action on the part of all Member States and of a high-level decision on the part of the EU legislature with regard to direct taxation still has a considerable impact on the effectiveness of the integration of the Internal Market and the achievement of the European Union's purposes. The analysis of "territoriality" in the context of EU tax law will, thus, serve as a lens through which to examine the possible ways forward for EU integration in direct taxation.

CHAPTER I

ALLOCATION AND LIMITS OF STATES' TAXING POWERS IN INTERNATIONAL TAX LAW: THE ROLE OF TERRITORIALITY

1. From (fiscal) sovereignty to (fiscal) territoriality.

It is commonly accepted that talking about fiscal territoriality means, first of all, talking about sovereignty: if the source of the taxing power of the state is the law, its ultimate foundation and bedrock is the taxing state's sovereignty. With certain limits, some of which are self-imposed, e.g. by way of constitutional norms, and some other derive - or are supposed to derive - from the concept itself of "sovereign legal order" and by the coexistence of analogous sovereign orders in the international arena.

This has been the traditional approach to the topic. In the following pages we will proceed to an analysis of this assumption, in order to verify whether or not it should still be considered as well founded. The answer to the question will be the premise for the definition of "territoriality" and of its current role in the allocation of taxing powers amongst states and, in particular, in the tax treatment reserved by states to non-residents and, more in general, to elements that are somehow alien to their legal order. The definition of this question would, then, constitute the essential ground to verify the possibility to reach and implement a homogeneous theory of localisation of income at international level - or, at least, within the borders of the European Union Internal Market - which constitutes one of the essential purposes of the research.

State jurisdiction to tax is justified, both in domestic and international law, as an attribute of statehood or sovereignty[5]. Naturally, jurisdiction should be conceptually

[5] McLure jr., C., *Globalisation, tax rules and national sovereignty*, in Bulletin of International Taxation, 2001, 328; Ingrosso, M., *Tributo e sovranità*, in Perrone, L., Berliri, C. (eds.), *Diritto tributario e Corte costituzionale*, Naples,

distinguished from sovereignty: if jurisdiction concerns the question of whether and under what circumstances a state has the right to regulate or rule over events and facts which are relevant for the community, sovereignty is the power by virtue of which jurisdiction is exercised. In other terms jurisdiction is both an aspect and the source of sovereignty[6].

According to contemporary scholarly opinion, a state's sovereign power - which manifests itself essentially through the issuance of juridical norms - is, first of all, preeminent over any other power within the national community. In short, it consists of the power to regulate all relationships within a state's community and to rule the community itself, identifying the interests and purposes to pursue and choosing how to attain them, even resorting to coercive measures. In other words, state sovereignty is a state's juridical power to govern itself in a manner that does not in any way depend on other international law subjects, such as other states[7].

In light of all the above, it is evident that fiscal jurisdiction cannot exist without fiscal sovereignty[8]. It follows that, according to mainstream scholarly opinion, if jurisdiction is an attribute of sovereignty, the limits to fiscal jurisdictions cannot but be similar to, if not coinciding with, those posed to national sovereignty[9]. On the other hand, it must, however, be reported that several influential authors have traced a clearer difference between sovereignty and jurisdiction, stating that the unlimited character of sovereignty should not automatically be attributed to jurisdictional powers as well[10].

2006, 138; Queralt, J.M., *La potestà tributaria*, in Amatucci, A. (ed.), *Trattato di diritto tributario*, Padua, 1994, vol. I, 144; Udina, M., *Il diritto internazionale tributario*, in Fedozzi, P., Romano, S. (eds.), *Trattato di diritto internazionale*, Padua, 1949, vol. X, 41; Giannini, A.D., *I concetti fondamentali del diritto tributario*, Turin, 1956, 53; Del Federico, L., *Tassa*, in Dig. Disc. Priv. - Sez. Comm., Turin, 1998, XV, 325. Other authors, nonetheless, have voiced the opinion that the traditional concept of "sovereignty" and, in particular, of "tax sovereignty" would be outdated and should be substituted by other concepts such as the supremacy of the law as the instrument by way of which the will of the peoples is exercised; on the point, see Liccardo, G., *Supremazia e obbedienza finanziaria*, in VV.AA., *Studi in onore di Victor Uckmar*, Padua, 1997, vol. II, 749.

[6] Brownlie, I., *Principles of Public International Law*, Boston, 1990, 299. North-American scholars traditionally distinguish three "categories of jurisdiction" or, better said, three ways state power manifests itself: jurisdiction to prescribe (i.e. legislative power), jurisdiction to adjudicate (i.e. jurisdictional power) and jurisdiction to enforce (i.e. the power to coercively implement state law).

[7] Chiarelli, G., *Territorio dello Stato (diritto costituzionale)*, in *Nov.mo dig. it.*, Turin, 1973, vol. XIX, 196; Gioia, A., *Territorio in diritto internazionale*, in *Dig. disc. pubbl.*, Turin, 1999, vol. XV, 262; Mortati, C., *Istituzioni di diritto pubblico*, Padua, 1975, vol. I, 100.

[8] Even though the concept of "sovereignty" has always been very difficult to define, especially in a context, such as the field of international law, characterised by the use of many different languages. In light of this difficultu, and the consequent risks of confusion, some authors - amongst which Kelsen - have suggested the elimination ot the concept of "sovereignty" from the field of international law. However, for a description of the problems connected to such concept and its evolution with regards to general international law, see Heller, H., *La sovranità - Contributo alla storia del diritto dello Stato e del diritto internazionale*, in Heller, H., *La sovranità ed altri scritti sulla dottrina del diritto e dello Stato*, Italian translation by Pasquino, P., Milan, 1987, 67; on the same point, with a deeper analysis of the scholarly debate about the definition and the limits of the concept of "sovereignty", see also, amongst others, Cortese, E., *Sovranità (storia)*, in *Enc. Dir.*, Turin, 1989, vol. XLIII, 205.

[9] Uckmar, V., *La tassazione degli stranieri in Italia*, in Uckmar, V. (ed.), *Il diritto tributario*, Padua, 1955, vol. XVIII, 22; Albrecht, A.R., *The taxation of aliens under international law*, in British Yearbook of International Law, 1952, 145.

[10] On this interesting, though not universally shared, theory, see, amongst others, as far as Italian authors are concerned, Croxatto, G., *L'imposizione delle imprese con attività internazionale*, Padua, 1965, 20, and, for Anglo-Saxon

In the field of international (tax) law, the concept of "sovereignty", when talking about states, must inevitably be further defined and described by limiting it to a specific territory. Therefore, the territory simultaneously is the direct/indirect object of the relevant power of the states and the measure of the extension of the state's territorial sovereignty, i.e. the space where such sovereignty is exercised in a stable manner[11]. To quote Chrétien, "*l'état a un territoire propre et une souveraineté propre. Il jouit de la souveraineté territorial. Jusqu'à l'extrême limite de ses frontières qu'il ferme par des barrières douanières, il est maître absolu en matière fiscale [...] C'est dans sa souveraineté territorial que l'état trouve l'unique source de son pouvoir d'imposition qui est ainsi illimité [...] En matière d'impôts, l'état jouit d'un pouvoir absolu au-dedans de son territoire tandis qu'il ne jouit d'aucun pouvoir en dehors de son territoire - sous réserve, bien entendu, des accords internationaux qu'il a contractés*"[12].

With the concept of "territorial sovereignty" ("*souveraineté territorial*") scholars have defined the right for all states to exercise their governing powers in a general and exclusive way within the borders of their country. The inevitable other side of the medal is the obligation for all other states to restrain from acting within the territory of another country without being "authorised". This is, in short, the essential meaning of the concept that scholars have traditionally defined as "territoriality".

Therefore, from a national perspective, and coming to the subject of taxation, the state's taxing powers constitute part of - and the expression of - that state's sovereignty. As far as taxation is concerned, state sovereignty manifests itself both through the legislative activity of the state concerned, in the context of which that state can determine the elements and/or the subjects on which/whom to levy taxes (and the intensity of said levy, with reference, for instance, to the extension of the tax base and the determination of the applicable tax rate), and through the authoritative "administrative" activity necessary to the enforcement of the tax provisions.

Also with regards to taxation, the relevance of the connection with the state's territory comes as a consequence of the connection linking fiscal sovereignty itself to the territory of the state exercising it, in the terms described above. In fact, if we move from a national perspective to an international one, territorial sovereignty is based on the

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scholars, though they embraced the theory only at a latter stage after European authors, Martha, R.S.J., *The jurisdiction to tax in international law - Theory and practice of legislative fiscal jurisdiction*, Deventer, 1989, *passim*. The view is not shared, for example, by German authors, who still tend to commit to theories according to which sovereignty and jurisdictional powers are supposed to entirely coincide.

[11] Espadafor, C.M.L., *Premesse internazionali dell'evoluzione della sovranità tributaria*, cited above, 12.

[12] Chrétien, M,, *Contribution à l'étude du droit international fiscal actuel: le rôle des organisations internationales dans le règlement des questions d'impôts entre les divers états*", in Recueil de Cours de l'Académie de droit international, 1954, 2, 15.

mutual recognition, by all states, of the independence of the other analogous subjects as their "counterpart", which is one of the reasons why the international legal order has been defined as being grounded on the equality of all states[13]. In other words, while on a domestic and purely national level the state is *superiorem non recognoscens*, which essentially means that the state does not have to deal with the problem of other similar subjects that may or may not influence its domestic actions and policies[14], this exact problem is the real essence of international law: how the single states, each of which constitutes a separate and autonomous sovereign subject with "limitless powers", may interact with one another.

Once again the focus shifts to the territory of the states and, more specifically, to the limit and threshold of the state's powers represented by that same state's territory: the exercise of the (taxing) powers of the state is legitimate insofar as it is justified by a connection between that exercise and the state's territory, as the threshold and limit to the state's sovereign powers.

Legal doctrine has generally distinguished between "personal sovereignty" and "territorial sovereignty", the first being defined as the supremacy the state has over (natural or legal) persons, comprising the right to extend its laws to regulate conducts and attach legal consequences to such conducts wherever the persons may be. On the other hand, territorial sovereignty is the power of a state to exercise its authority over all persons, events, things and events within its territory[15-16]. This distinction should be borne in mind, as it will be essential for the prosecution of the present work, since it has influenced many of the scholarly debates concerning the topic of the research.

However, the conceptual difference traced between "territorial" and "personal" sovereignty does not seem to be entirely convincing, as it seems to imply that the "territorial" conception of sovereignty is the only one of the two being based on the existence of a link between the state and the object or element on which sovereign powers are exercised. Nonetheless, if we look closer, it is evident that sovereignty from a "personal" perspective is not deprive of that connection, being it simply based on a

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[13] Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 7; Chiarelli, G., *Territorio dello Stato (diritto costituzionale)*, cited above.

[14] On this subject, Baggio talks about a "*juridical solipsism*" of the state and of the concept of sovereignty if seen from a purely domestic and national perspective; see Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 7.

[15] Martha, R. S. J., *Extraterritorial taxation in international law*, in Meessen K. M. (ed.), *Extraterritorial jurisdiction in theory and practice*, Dresden, 1996, 19; Conforti, B., *International law and the role of domestic legal systems*, Rome, 1993, 133; Espadafor, C.M.L., *Premesse internazionali dell'evoluzione della sovranità tributaria*, in Riv. dir. trib. int., 2013, 3, 11.

[16] For a definition and analysis of the concept of "territory of a state", see Biscaretti di Ruffia, P., *Territorio dello Stato*, in *Enciclopedia del Diritto*, Milan, 1992, vol. XLIV, 333; Chiarelli, G., *Territorio dello Stato (diritto costituzionale)*, cited above; Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, Milan, 2009, 34. For an analysis of the crisis of "territoriality" in general terms, see Irti, N., *Norma e luoghi*, Rome, 2001.

different type of link between the element in question and the territory of a state: in order for a state to be considered as having the right to extend its laws to regulate conducts wherever a certain person may be, that person must be somehow connected to (the territory of) that state.

It is, therefore, more appropriate to refer not to a distinction between "territorial" and "personal sovereignty", but to a distinction between territorial connections of an objective nature and territorial connections of a subjective nature. This distinction is the one on which the entire dialectical relationship between source and residence in the field of (international) tax law is based. The concept will be made clearer in the following pages of the research when we will trace the distinction between "territoriality as a principle" and "territoriality as a criterion".

It is also true that the affirmation of new players on the international (tax) arena has deeply modified the traditional perspective through which scholars used to look at the question of sovereignty. Some have even stated that the coming to light of supra-national legal orders, such as the European Union, has caused the idea itself of sovereignty to lose most of its relevance. These new entities - and especially, for the purposes of the present research, the European Union legal order[17] - have not only imposed limitations on the states' sovereignty, but they also "forced" them into a process which, on one hand, leads them to giving up some of their sovereign power to the entity itself, which holds an exclusive power to regulate certain matters that were previously ruled only by state law, and, on the other hand, compels the states to enact all necessary measures towards a sort of "mutual coordination" of their sovereign powers in certain fields of law.

As a consequence of all the above-mentioned factors, the analysis of the relationship between international law and domestic law has, therefore, shifted more and more towards an investigation focusing mainly on the relationship between juridical norms rather than between sources of law, in the context of a unitary legal order[18]. The Italian Constitutional Court has, for example, recognised and accepted, through an

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[17] A different reasoning should apply, for example, to the effects played on state sovereignty by the membership of the United Nations, whose system (provided that it is quite difficult to define the United Nations as a proper "legal order") has more limited effects on the states' freedom to act than the European Union.

[18] We will not dwell on the age-old debate between "dualism" and "monism" in the field of international law, especially since the debate has now lost most of its relevance and, in any case, because the topic goes outside the scope of the present research. On the point of the right perspective for the study of the concept of "sovereignty" in the new international legal order, with specific attention to international law law, see, amongst others, Bizioli, G., *Il processo di integrazione dei principi tributari nel rapporto fra ordinamento costituzionale, comunitario e diritto internazionale*, Padua, 2008. On the debate between "dualism" and "monism", see Sacchetto, C., *Il diritto internazionale tributario tra norme del sistema costituzionale italiano, effettività ed utopia*, in Perrone, L., Berliri, C. (eds.), *Diritto tributario e Corte costituzionale*, Naples, 2006, 300; Amatucci, A., *Il conflitto tra norme internazionali ed interne tributarie*, in Riv. Dir. Trib. Int., 1999, 96.

interpretation of Articles 11 and 117 of the Italian Constitution, the relevance of European Union law within the domestic legal order, irrespective of whether such law has effectively been implemented by the Italian legislature or not[19].

This new general perspective on the relationship between European and international law on one hand and national law on the other hand has led to remarkable consequences on the external limitations posed to state sovereignty and to the state's power to legislate.

In light of all the above, and coming to the subject of taxation, the debate on the extension of the state's fiscal sovereignty on an international level has focused on the question concerning the existence of limits posed by international law to the states' taxing powers, i.e. the states' powers in establishing and enforcing tax laws[20]. Which essentially amounts to a question related to the conceivable existence of limitations to the possibility for states to choose which facts, things or persons to subject to taxation, or, in other terms, to the possible need for a connection between such elements and the territory of the taxing state.

It goes without saying that the question at issue has become significantly more relevant with the progressive evolution of modern tax systems towards personal forms of income taxation, with the consequent need, for most countries, to determine and measure the overall ability to pay of a taxpayer who is personally linked to the territory. More specifically, it has been observed that, especially after World War II, states' economies have become more and more intertwined and dependent on one another, thus leading states to a tendency towards an attempt to expand their taxing powers beyond their borders, to circumstances, things or events that are, at least in part, extraneous and unrelated to their territories[21].

While, in the past, authors have essentially favoured a vision according to which the states' taxing powers should encounter general internal limitations connected to their territorial borders[22], in more recent times, as a direct consequence of the above-mentioned tendency of the states towards an expansion of their taxing powers, as it will be developed in the further pages of this work, scholars have come up with doctrines based

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[19] The same kind of argument has been applied to the provisions and principles established by the European Convention on Human Rights. Which, according to the Italian Constitutional Court, are relevant within the domestic legal order (with obvious consequences in the field of taxation as well) by virtue of Article 2 of the Constitution, that recognises and guarantees fundamental human rights and, consequently, implies the efficacy of such rights, as established by the ECHR, as constitutional rights within the Italian legal order.

[20] Micheli, G.A., *Profili critici in tema di potestà di imposizione*, in Riv. dir. fin., 1964, 1, 19; Albrecht, A.R., *The taxation of aliens under international law*, cited above, 148.

[21] Sacchetto, C., *Territorialità (diritto tributario)*, in *Enciclopedia del Diritto*, Milan, 1992, vol. XLIV, 306.

[22] This theory, which has now been considerably tempered by contemporary authors, had its grounds on a conception of taxing powers as manifestation of territorial jurisdictional powers of the state over persons and things located within its territory.

on the theoretical absence of any bound to the states' powers to tax also elements which are located outside their borders[23]. At the same time, the current structure of the international community, balanced by the general mutual recognition of the states' independence and sovereignty, was (and is) at stake, with the consequent (practical and diplomatic) need to trace some inevitable limitations to the states' taxing powers when expanding beyond their territories[24].

It followed that, in the words of the authors that have traditionally dealt with the subject at issue, the concept of "territory" has been the almost exclusive focus when discussing possible international bounds to the exercise of the states' taxing powers. All of these works, as it will be further developed, have referred to a concept of "territory" not only as the place where a state's tax law may be fully valid and effective, but also, and foremost, as a space within which the elements giving rise to taxation (i.e., as far as the present research is concerned, income) should be, in a general sense, located.

2. The territory of the state as limit and measure of the states' taxing powers: "material" and "formal" territoriality.

It has been stated that no other concept, in the field of tax law, has attracted as much attention as the concept of "territoriality of taxation" has and that no other principle has influenced the development of all studies of international tax law as the principle of territoriality has[25]. The abundance of works on the point has led the concept of "territoriality" to being, nowadays, considerably ambiguous, especially if we consider the different ways in which the concept itself is used and described in different fields of (tax) law. For example, as it will be further discussed in the continuation of the present research, "territoriality" as interpreted and defined in the field of international tax law has been given a partially different meaning than the one that the Court of Justice of the European Union seems to have developed[26].

Territoriality is a concept (or, according to some, a principle[27]) that, by the nature of its object, relates primarily to the field of international law, having the effect to limit

[23] It has been correctly highlighted that one of the reasons behind this general (and quite controversial) statement was - and still is - the attempt to combat international tax evasion.
[24] One of the ways this attempt to limit the uncontrolled expansion of states' taxing powers beyond and outside their borders has been put in place was by the affirmation of the so-called "revenue rule", which, as it will be further developed, prevents states from enforcing their tax provisions (e.g. collecting taxes) in another state's territory without authorisation.
[25] Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 303.
[26] The point will be further developed in Chapter II.
[27] We will see in the following pages of the research whether or not such definition is appropriate and correct and in which terms.

the efficacy or the validity of tax rules and essentially operating in a intra-states scenario. Nonetheless, the questions relating to territoriality have their consequences primarily on domestic law, since, as it will be argued, it is each state's domestic law that regulates the conditions for the validity and efficacy of its laws.

Thus, an analysis of territoriality should inevitably start from an overview of the national implications of the concept at issue.

The origin and the evolution of the theories concerning the principle of territoriality in the context of national tax law have drawn inspiration from the concepts that, on the same point, have been developed in other fields of juridical studies, such as public international law, criminal law, conflicts of laws or administrative law[28]. If transposed in the field of international tax law, the concept of "territoriality" is, by definition, linked with the concept of limitation to the states' taxing powers.

According to this view, the territory is conceived not only as an essential element for the existence of each state, but also as the physical area within which the power and authority of the states can be exercised[29]. With more specific regards to tax law, the principle of territoriality has been defined by some as the maximum expression of the states' need to rationally regulate the concurring taxing powers of the states, with a direct and strict connection to the general concept of "state sovereignty". In other words, the argument is that, given that the state can fully exercise its sovereign powers within its territory, and given that state sovereignty constitutes the foundation and justification of the states' taxing powers, it follows that the states' taxing powers must be territorially limited[30].

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[28] This influence is also partially due to the undisputable fact that the analysis of the principle of territoriality in the field of tax law is relatively recent, as opposed to what happened in other fields of law, where the elaboration on the point of territoriality and on the relationships between the powers of all states in the international arena has been a traditional focus of interest. While the first enunciation of the principle of territoriality dates back to Francisco Suarez's words in his *Tractatus de legibus ac Deo legislatore* (1612) and, later on, to Hobbes' *Leviathan* (1651), authors from all areas of law are unanimous in stating that concept of "territoriality" has gotten its first real theoretical (and practical) elaboration after the affirmation of modern states, traditionally identified with the signing of the 1648 Westphalia Peace Treaty, when the territory of the state becomes relevant as an independent space and, consequently, as a measure and limit to the efficacy of the state's legal order. On the evolution of the principle of territoriality as inherently intertwined with state sovereignty from an historical perspective see Fardella, F., *Il dogma della sovranità dello Stato - Un consuntivo*, in Riv. Dir. Pubbl., 1985, 1066.

[29] On the point, see Udina, M., *Trattato di diritto internazionale*, Padua, 1949, 57. According to his opinion, the state's taxing powers are not unlimited, neither in practice nor by law, since the legal order from which the taxing powers derive is not unlimited. According to the author, the essential trait of the state's sovereign power is that its provisions may be coercively enforced, if necessary, but within certain limits, one of which is represented by the state's territory. Under this view, the territory is not only an essential element for the existence of all states, but also the area within which the sovereign governing power of the state can be exercised. Exceptionally, the state's governing powers may go beyond their territorial limits, but only when such enforcement is designed to have its effects only within the territory of the state or when the foreign country provides its authorisation (freely or by virtue of international obligations or international law principles). In all other cases, according to the author, all state provisions that cannot be enforced abroad should not be considered as legally binding or even law, but rather political or moral precepts that cannot be considered as an expression of sovereign power.

[30] Manganelli, A., *Territorialità dell'imposta*, in *Dig. disc. priv. - sez. comm.*, Turin, 1994, vol. XV, 366.

Therefore, the principle of territoriality as it stands in general international law (provided that we will verify in the following pages of the research whether or not territoriality can actually be considered as an international law principle when transposed in the field of taxation) implies that a state may exercise its jurisdiction with regards to all persons and objects which are characterised by a connection with its territory, irrespective or their nationality or origin[31].

The above-mentioned definition of the concept of "territoriality", when transposed in the field of tax law, generally conceived as both an expression of and a limit to the sovereign power of the states[32], has led scholars to tracing a clear distinction between an "internal" and an "external" feature of tax laws[33].

From a domestic perspective, the effects of the principle of territoriality coincide with the statement of the exclusivity of tax law. More in detail, a state's tax provision is generally considered as strictly territorial, which means that said provision can have full effect only within the state's territory, with the consequent exclusion of the possibility for other states' laws to be validly effective in the same territory[34]. In other terms, in accordance with the principle of territoriality, all events and facts having place within a certain territory are ruled and governed by the (tax) provisions established by the state governing that territory[35]. Such a statement is the product of a traditional tendency on the part of the states to strenuously defend the exclusivity of their taxing powers within their own territory, with specific consequences particularly on the possibility to enforce national tax provisions in foreign countries[36].

That being established, it must, however, be highlighted - even though this problem will be described more in detail in the following pages - that, in the contemporary era, the principle of exclusivity of tax law with regards to a specific territory, though still perfectly valid and applicable, at least theoretically, has undergone deep changes and modifications, essentially as an effect of the role of international or supranational institutions and entities, such as the European Union.

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[31] Territoriality has not always been the dominating principle for the attribution and allocation of jurisdiction in international tax law. For a historic overview, see Ryngaert, C., *Jurisdiction in international law*, Oxford, 2008, *passim*.

[32] For a brief overview of the history and evolution of the principle of territoriality in general terms and, more specifically, with regards to international tax law, see, amongst others, Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 1; Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 307-310.

[33] Rohatgi, R., *Basic international taxation. Principles*, Richmond, 2005, 14.

[34] The question relates to the efficacy of tax law in a spatial sense. On this point, the contribution given by Italian scholars has been paramount in tracing the difference between "internal" and "external" features (and effects) of territoriality. See, amongst others, Amatucci, A., *Legge tributaria*, in *Enciclopedia Giuridica*, Rome, 1994, vol. XX, 1; Micheli, D., *Legge (diritto tributario)*, in *Enciclopedia del Diritto*, Milan, 1992, vol. XXIII, 10; Barile, G., *Appunti sul valore del diritto pubblico straniero nell'ordinamento nazionale dello Stato*, Milan, 1948.

[35] As will be further developed, the state's (tax) law is binding not only on citizens, but also on foreigners having a certain link or connecting element with the state's territory.

[36] This aspect concerns what it will be further defined as "formal territoriality".

Going back to the main topic, the principle of territoriality, if seen from an "external" point of view, essentially deals with the validity and the efficacy of a state's tax law outside the borders of that state's territory. On this point, it must be highlighted that the debate on "external" territoriality and, more in general, on the existence of limitations to a state's taxing powers has so far traditionally focused, especially through the words of Italian authors[37], on the distinction between two different profiles: a "material" aspect of external territoriality on one hand - concerning the content of tax provisions or, in other terms, the state's power in identifying facts, things and/or persons to subject to tax within or outside the territory of the state itself[38] - and, on the other hand, a "formal" profile of external territoriality, dealing with the problem of the actual enforcement of the state's tax law in a foreign country[39-40].

From the first point of view ("material" territoriality), the question is whether the state is bound to tax only facts and circumstances taking place within its territory or, on the contrary, territoriality must be interpreted in a broader sense, which essentially amounts to asserting that the state can tax foreign subjects.

On this point, authors have traditionally taken the position that there are no limits to the taxing powers of a state and that, consequently, each state is free to tax every income and other tax object even if foreign, alien or in some other way extraneous to the taxing state, and, according to some, even though entirely devoid of any link with the territory of the state itself. In different and simpler words, according to the main part of the traditional doctrine, each state is theoretically free to issue any law imposing tax on every kind of piece of income, irrespective of whether or not such income has anything to do with the taxing state concerned[41].

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[37] On this point, see especially Fransoni, G., *La territorialità nel diritto tributario*, Milan, 2004; Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above; Bizioli, G., *Il processo di integrazione dei principi tributari nel rapporto tra ordinamento costituzionale, comunitario e diritto internazionale*, cited above; Croxatto, G., *L'imposizione delle imprese con attività internazionale*, cited above, 38; Garbarino, C., *Manuale di tassazione internazionale*, Milan, 2008, 10; Gaffuri, G., *La tassazione dei redditi d'impresa prodotti all'estero. Principi generali*, Milan, 2008.

[38] I.e. with regards to all elements implying relationships with territories or legal orders of more than one state and with concern to which more than one state can levy taxes; see Vogel, K., *Il diritto tributario internazionale*, in Amatucci, A. (ed.), *Trattato di diritto tributario*, Padua, 1994, 691.

[39] The latter problem, which, in the field of tax law, has given rise to the (now partially out-dated) debate on the so-called "revenue rule" and which, though in necessarily different terms, is common to criminal law as well, escapes the scope and purpose of the present research, since it deals with more "administrative" aspects of the problem, and, therefore, will only be traced in its essential lines.

[40] It has been stated that, while, on one hand, the distinction between territoriality from a "formal" perspective and territoriality from a "material" perspective has constituted the highest point of the scholarly debate on the question of the allocation of taxing powers amongst states, on the other hand this theory has "ratified" the international "anarchy" in States' legislation in the field of tax law, giving rise to problems connected to international double taxation and to the consequent "failure" of the principle of territoriality with respect to the practical purpose it had been created for. On the point see, amongst others, Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 306; Martha, R.S.J., *The jurisdiction to tax in international law - Theory and practice of legislative fiscal jurisdiction*, cited above.

[41] This position finds its grounds in the acceptance of the so-called theory of universality of the legal order and the following assertion according to which the state does not encounter any initial limitation to its powers other than

From this perspective, the state's taxing powers have been defined as theoretically "unlimited" and "absolute". "Unlimited" means that the exercise of such taxing powers cannot be in any way restricted from a geographical point of view, while "absolute" means that the state's taxing powers can produce their effects towards anybody, being it an individual or a juridical person[42].

The position described above, traditionally held by continental authors (mostly following the theories first formulated by German doctrine), has been greatly influenced by the well-known *Lotus* judgement rendered by the International Court of Justice[43], which, in short, stated that, in absence of any specific prohibition posed by international treaties, the general duty for all states to refrain from exercising their governing power in foreign territory does not imply that states cannot exercise, in their own territory, their jurisdiction with regards to facts, circumstances, events and subjects which take place or are somehow located abroad.

On the other hand, a different reasoning is supposed to apply to the second profile, i.e. the one concerning the "formal" aspect of territoriality, that is to say the one involving the actual extraterritorial exercise of tax collection, tax recovery or any other act or deed aimed at enforcing tax provisions. With regards to this aspect, authors have traditionally shared the opinion that any actual exercise of such kind on foreign territory would amount to a violation of international law[44-45].

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those stemming directly from its own legal order with regards to the categories of elements, facts, subjects, circumstances and events that the state itself intends to discipline.

[42] Couzin, R., *Corporate residence and international taxation*, Amsterdam, 2002, *passim*.

[43] Permanent International Court of Justice, judgement 9 September 1927, *Lotus*. The Court essentially stated that the duty not to exercise sovereign powers in foreign territory does not automatically entail a prohibition for the state to exercise, in its territory, its jurisdiction with regards to facts and subjects located abroad, being it a prerogative which is based on the very core of the concept of "sovereignty" ("*it does not, however, follow that any international law prohibits a state from exercising jurisdiction in its own territory in respect of any case which relates to acts which have taken place abroad*). More in detail, the International Court of Justice has found that states should not be denied the possibility to extend their laws and jurisdiction to persons, things or events outside their own territory according to the principles that said states deem most useful. On the other hand, however, the *Lotus* judgement acknowledged that territorial sovereignty should not be exercised in the absolute absence of any boundaries, since the state "*may not exercise its power in any form in the territory of another state*".

[44] The debate on the point has been clearly described in a number of "classic" Italian works concerning territoriality and international limitations to the taxing power of the states. See especially Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 303; Croxatto, G., *La imposizione delle imprese con attività internazionale*, cited above, 47; Berliri, A., *Principi di diritto tributario*, Milan, 1952, 100; Garbarino, C., *La tassazione del reddito transnazionale*, Milan, 1990, *passim*; Lupi, R., *Territorialità del tributo*, in *Enciclopedia Giuridica*, Rome, 1994, vol. XXXI, 1; Udina, M., *Il diritto internazionale tributario*, cited above, 17; Manganelli, A., *Territorialità dell'imposta*, cited above, 366; Cordeiro Guerra, R., *La potestà impositiva ultraterritoriale*, in Cordeiro Guerra, R., (ed.), *Diritto tributario internazionale - Istituzioni*, Padua, 2012, 55; Giannini, A.D., *I concetti fondamentali del diritto tributario*, cited above.

[45] The question of territoriality from a "formal" perspective escapes the scope of the present research, which will mainly focus on the implications of territoriality in a "material" sense. On the point of "formal territoriality", suffice it to say that for many decades the question was ruled by a general principle of non-cooperation amongst states in the realisation on their own territory of other states' tax credits, which could be waived only by virtue of treaties and conventions that, according to such traditional opinion, had to be conceived as exceptions to the general non-cooperation rule. Modern tax scholars are now mostly unanimous in defining this position as out-dated and inadequate to the levels of development which have been reached by the international economic integration and tend to interpret bilateral conventions providing for mechanisms of cooperation amongst states in the field of tax recovery not as exceptions to the general rule, but as proof and confirmation of a tendency

Starting from the "*Lotus* doctrine" (though not specifically related to taxation, but rather concerning more general aspects of international law), authors have elaborated a distinction between formal and material exercise of taxing powers, differentiating between the enforcement of tax law, which is an expression of formal territoriality and, thus, precluded beyond national borders, and legislative power with regards to tax provisions (material territoriality), which may very well take into consideration taxpayers or elements located or realised, wholly or partly, outside the territory of the state. In the latter case, the juridical effects of the national provision expand to elements located outside national borders[46].

Starting from these premises, it has been highlighted that the result of the approaches described above would essentially lead to the statement that the tax norm providing for the taxation of an income located abroad would be nothing more than a sort of "program" of possible future actions by the state (the actual enforcement of the law abroad), which, if enacted, could infringe international law in case the state actually wished to give execution to the norm in foreign territory through its own coercive powers and means[47].

Furthermore, several authors have suggested that such "traditional" positions would lead to a sort of paradox, since they would result, on one hand, in the exclusion of the possibility to recover, in foreign territory, taxes due by taxpayers in relation with events or facts that have occurred within the state trying to recover such taxes, and, on the other hand, in allowing states to recover taxes due in relation to events or facts which could be, in theory, totally devoid of any effective link or connection with the taxing state[48]. The absence of territorial limits to the definition of the events, facts, subjects or things that can be considered as giving rise to taxation seemed too arbitrary and capable to give way to a considerable level of uncertainty in international tax relationships (amongst states and between states and taxpayers).

towards a more integrated approach to the subject. However, even if legal scholars have voiced this opinion for some time now, there has been no significant change in the case law on the point so far, if we exclude the peculiar case of the European Union. Some scholars, such as Croxatto and Udina, have even advocated the creation of a sort of "international tax court" whose purpose would be to settle disagreements amongst states in the field of cross-border tax recovery.

[46] Maisto, G., *Brevi riflessioni sulla evoluzione del concetto di 'genuine link' ai fini della territorialità dell'imposizione tributaria tra diritto internazionale generale e diritto dell'Unione Europea*, in Riv. Dir. Trib., 2013, 10, 889; Vogel, K., *Klaus Vogel on double taxation conventions*, London, 1997, 11.

[47] Cordeiro Guerra, R., *Principio di capacità contributiva e imposizione territoriale*, in Salvini, L., Melis, G. (eds.), *L'evoluzione del sistema fiscale e il principio di capacità contributiva*, Padua, 2014, 165. The question of the effectiveness of tax law, which, as it will be further developed in the following pages, has been part of the debate on the principle of territoriality from an international law perspective as well, has been also highlighted by Bizioli, G., *La capacità contributiva nella dimensione internazionale*, in Salvini, L., Melis, G., *L'evoluzione del sistema fiscale e il principio di capacità contributiva*, Padua, 2014, 253.

[48] This hypothetical paradox is highlighted, amongst others, by Lupi, R., *Territorialità del tributo*, cited above, 3.

In light of these assumptions, part of the legal doctrine, mainly (but not exclusively) from the Anglo-Saxon area, has now voiced the opinion that the distinction traced above between the legitimacy of a "boundless" taxing power on the part of the state (as far as "material" territoriality is concerned) as opposed to the illegitimacy of the corresponding enforcing power (with regards to "formal" territoriality) is too strict and not able to actually reflect the reality of the ways modern states choose to regulate and exercise their fiscal powers.

This more recent position has found part of its grounds in theories and assertions that have resulted in a general statement according to which a state could exercise some of its sovereign powers only in presence of a sufficient "attachment", "connection" or "link" between the situation at issue and its own legal order (or, as is often the case with regards to tax law, between the situation at issue and the state's territory)[49]. Part of the international legal doctrine has, therefore, highlighted the need to limit the exercise of the state's sovereign powers only to situations in which an effective, actual and stable link between the subject and the state can be identified[50-51].

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[49] This theory has been developed, for example, with regards to the topic of diplomatic protection, which essentially revolves around the protection, outside of national borders, of subjects which are linked to a state by citizenship or nationality and the consequent invocation by a state of the responsibility of another state for an injury, breach or violation caused by an internationally wrongful act of the latter state to the detriment of a national or citizen of the former state. On the point, a paramount contribution, which is often mentioned also in every tax-focused analysis of the problem at hand, was given by the International Court of Justice's *Nottebohm* judgement (April 6, 1955, *Liechtenstein v. Guatemala*, *ICJ Rep.* 1955, 4). Without going into further details which elude the scope and purposes of the research, suffice it to say that, in that judgement, the International Court of Justice essentially denied a state the possibility of exercising its diplomatic protection powers on one of its national in case there is no proof of a "*genuine connection*" between the citizen and the state itself ("*a State cannot claim that the rules it has thus laid down are entitled to recognition by another State unless it has acted in conformity with this general aim of making the legal bond of nationality accord with the individual's genuine connection with the State which assumes the defence of its citizens by means of protection as against other States*"). Similar tendencies can be found also in the international practice concerning the fields of the law of the sea and criminal law (and criminal jurisdiction on an international level). However, some authors have highlighted the need to be cautious in extending such principles to a wider scope of application than the one given by the judgement itself, since the case dealt with a very specific and peculiar (and not related to tax law) fact pattern. On the point, see Maisto, G., *Brevi riflessioni sulla evoluzione del concetto di 'genuine link' ai fini della territorialità dell'imposizione tributaria tra diritto internazionale generale e diritto dell'Unione Europea*, cited above. Scholars have also cited the *Barcelona Traction* judgement by the International Court of Justice (February 5, 1970, *Barcelona Traction, Light and Power Company, Limited*, *ICJ Rep.* 1970, 3), also concerning the topic of diplomatic protection, as another demonstration of the existence of territorial limits to the exercise of taxing powers and that such limits are based on the need to find an effective connection with the territory of the state. On the other hand, it has been highlighted by some authors, however, that the judgement mentioned above would not be able to demonstrate the principle at issue, but would rather constitute the proof of its exact opposite, since the Court has not clearly asserted the need, pursuant to general international law, of territorial linking criteria in order for a state to exercise its sovereignty ("*in the field of diplomatic protection of corporate entities no absolute test of the genuine connection has found application in practice*"). See Maisto, G., *Brevi riflessioni sulla evoluzione del concetto di 'genuine link' ai fini della territorialità dell'imposizione tributaria tra diritto internazionale generale e diritto dell'Unione Europea*, cited above. That being said, it has also been argued that the principles expressed in both of the above-mentioned judgements could not be automatically applied to the field of tax law, especially since what might constitute an appropriate "connecting factor" to legitimise the exercise of states' sovereign powers in certain fields of law (e.g. private international law, diplomatic protection, jurisdiction…) may not be as appropriate with regards to tax law, given the increasing mobility of persons, production factors, riches and other fiscally relevant elements. This circumstance appears particularly evident if we think about electronic commerce.

[50] It must be highlighted that, according to the Italian main doctrine, the concept of "linking factor" as far as (international) tax law is concerned is radically different from the meaning that the word "link" has in the field of

Starting from these theories, which are nowadays shared amongst the majority of continental European scholars as well, some authors have then elaborated a theory revolving around the so-called "economic allegiance" concept[52], that, according to the mainstream opinion, would essentially coincide with the concept on which the "benefit theory" is based, on which we will say more in the continuation of this work[53].

It should then be concluded that the state's power to legislate and to levy taxes is not a consequence of that state's power over its territory and over the persons located therein and, therefore, cannot be considered as inherently limited by the borders of the territory itself. It is, rather, the state's legal order, and, in particular, the state's tax law, that establishes the elements that should constitute the object of the state's taxing powers and the persons upon which the tax burden should be imposed. It follows that it is not possible, at least from a purely national perspective, to identify *a priori* general limits to the state's taxing powers and that, consequently, a general principle of territoriality should be considered as non-existing[54]. That is also because the mere legislative activity of the states in the field of taxation does not imply *per se* any extra-territorial exercise of state sovereignty or state jurisdiction.

Possible limits should, then, be found exclusively in the provisions, principles and rules that constitute part of the state's legal order[55]. Several states' national legislations recognise, in principle, the existence of limitations to the exercise of taxing powers on foreign elements. However, the characteristics of this "rule" are so vague and different that a hypothetical "genuine link principle", according to which states may levy taxes only on elements that are effectively and reasonably connected to the states' territory, would not be easy to define in a uniform manner. On the other hand, there are also (rare)

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private international law, where the effect of the "link" is to lead into a state's legal order provisions coming from other states. While, in tax law, linking factors do not refer to any foreign law, but serve the purpose to define and limit the scope of application of national taxes. On the point, other scholars, mainly belonging to the German area, have stated the exact opposite, recognising some similarities between the concepts of "linking factor" in the field of private international law and tax law.

[51] Some of the Authors advocating this view have taken their thesis to extremes, by stating that a tax established by a state without any reasonable link with its territory or its legal order would end up being in violation of a "general principle of law recognised by civil nations" and, therefore, sanctionable pursuant to Article 38 of the International Court of Justice Statute (according to which generally recognised principles are included amongst the sources of international law). On the point, see Gaffuri, A.M., *La tassazione dei redditi d'impresa prodotti all'estero. Principi generali*, cited above, 347.

[52] See Hellerstein, W., *Jurisdiction to tax income and consumption in the new economy: a theoretical and comparative perspective*, in Georgia Law Review, 2003, 1, 6, which justifies "*substantive jurisdiction to tax*" by virtu of the "*relationship of the State to the person with the right to the income*" or the "*relationship of the State to the property or activities that produce income*".

[53] Kaufman, N.H., *Fairness and the taxation of international income*, in Law and Policy in International Business, 1998, 158, 184.

[54] Manganelli, A., *Territorialità dell'imposta*, cited above, 368.

[55] Croxatto, G., *L'imposizione delle imprese con attività internazionale*, cited above, 27; Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 314.

forms of taxation that do not entail any territorial link between the state and the taxpayer and/or the income subject to tax[56-57].

3. Territoriality as a parameter for the allocation of taxing powers amongst states: the international (tax) law perspective and the admissibility of extraterritorial taxation.

Essentially there is no country that forgoes taxing domestic-source income, irrespective of whether such income is derived by nationals, aliens, residents or non-residents. On the other side, however, national legislations can be quite different with respect to what they consider being "domestic-source income" or to the dissimilar ways states tax foreign-source income, which leads to problems connected to extraterritoriality of taxation. Even though, according to some authors, taxation of foreign income is always and inherently extraterritorial[58] and even though territoriality of taxation is generally seen as a paramount standard at least in the majority of Western countries[59].

Criticism of extraterritorial taxation is generally based on considerations of equity or economic factors rather than on arguments derived from positive public international law, especially since general international law does not provide for any conflict rule to regulate the "order of preference" in case of concurrent tax jurisdiction, nor does it entail ways to deal with the disparity between the states' fiscal concepts. Therefore, problems

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[56] An example is provided by the so-called "unitary taxation" system in place in California and in some other U.S. states. Pursuant to this model, a part of the income produced abroad by non-resident companies is anyway attributed to (and taxed upon) secondary establishments located in the territory of the state and controlled companies established therein. The implementation of this peculiar linking criterion may lead to taxing foreign-source income received by a non-resident even if the activity performed in the territory of the taxing state has not in any way contributed to the production of such income. According to some authors (Martha, R. S. J., *Extraterritorial taxation in international law*, cited above, 28), this technique employed to determine the worldwide income of the corporation is "abusive", even to the point of amounting to an example of extraterritorial taxation of non-resident corporations and of an "abuse of rights".

[57] As far as Italy is concerned, it has been highlighted that some Italian tax provisions would be deprived of any effective and stable territorial link between the state and the taxpayer or the income. That is the case, for example, of the rule establishing fiscal residence (and thus worldwide taxation) by virtue of the simple registration in the list of citizen, but also of the rule taxing capital gains accrued on shares held by an Italian citizen and concerning companies established abroad. Of this opinion, Maisto, G., *Brevi riflessioni sulla evoluzione del concetto di 'genuine link' ai fini della territorialità dell'imposizione tributaria tra diritto internazionale generale e diritto dell'Unione Europea*, cited above; Melis, G., *La nozione di residenza delle persone fisiche nell'ordinamento tributario italiano*, in Rass. Trib., 1995, 1034.

[58] Martha, R. S. J., *Extraterritorial taxation in international law*, cited above, 19.

[59] Emphasising territoriality of income tax legislation generally leads to source-based taxation. However, in recent Latin American legislation and treaties, the principle of territoriality has somewhat receded. Moreover, even amongst countries confining themselves to taxing purely domestic-source income and excluding all foreign-source income from their tax bases there may be considerable differences in practice. For example, Hong Kong, Uruguay and Kenya tax both natural persons and corporations only with respect to their domestic source income, while France taxes natural persons on their worldwide income and corporations on their domestic income only. The Netherlands only some foreign income (e.g. dividends and income from foreign permanent establishments) is exempted from taxation, provided that such income is taxable in the country where it arose. Both the United Kingdom and Japan have moved towards territorial tax systems within the past few years, and several recent proposals for United States corporate tax reform propose or consider this option as well.

concerning extraterritorial taxation are generally solved, even though not entirely, through double taxation conventions.

If it were to be accepted that the exercise of jurisdiction can effectively be considered "illegal" from an international law point of view, then one should be able to find, in all the many cases where states have attempted to tax without the necessary legal basis, effective ways to counteract these attempts in international (tax) law. *Rebus sic stantibus*, if we exclude the current double taxation conventions network, which some consider deeply unsatisfactory, "pure" international law seems to be devoid of such instruments. The same does not apply to other legal orders (provided that the international arena could ever be defined as a "legal order"), such as the European Union.

It has even been suggested that a - probably utopic - way to suppress extraterritorial taxation caused by distortion in fiscal categories such as "residence", "nationality", "income", etc., would be to reform tax treaties towards a unification of the concepts by providing exhaustive definitions that do not depend on national law, regulations or judge-made interpretation[60].

In light of all of the above, some of the legal scholars who have dealt with the question at issue, more receptive towards the idea of the need to "contain" states' taxing powers in the interest of the international community, have tried to argue that the absence of any territorial limit to the taxing powers of the state - or, better, to the power of the state to define its tax base - would be incompatible with international law as the complex of principles and rules regulating relationships amongst states[61], being it theoretically necessary, according to generally recognised principles, to find a (reasonable and genuine) link between the elements on which tax is levied and the state's legal order[62].

The levying of taxes in a state might, in fact, to a certain extent, undermine the conditions for the exercise of taxing powers by another state, which could have to

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[60] See, for example, Martha, R. S. J., *Extraterritorial taxation in international law*, cited above, 26.

[61] International law is generally seen as the complex of principles and rules aimed at solving possible conflicts derived by the coexistence of states as sovereign entities. Consequently, international law is not concerned with all events and situations whose juridical effects are limited within the borders of a single legal order, involving (public or private) subjects who are all part of the same state. According to a more "archaic" theory (which is nowadays generally considered out-dated), international law could be concerned with tax law only in the hypothesis a state or an international organisation were able to levy tax on another state and, therefore, fiscal relationships in the "classical sense" (state-taxpayer) could not constitute the object of international law provisions because such relationships are merely between a state and its citizens, nationals or subjects. On the other hand, more modern theories (e.g. Conforti, B., *Diritto internazionale*, Milan, 2014) have highlighted that international law may not regulate not only relationships between states, but also has effects on certain aspects of the relationship between the subjects of the same national community and between the state and its subjects.

[62] For a summary of the essential lines of the debate on the point and the main positions voiced by authors, see Fantozzi, A., *Diritto tributario*, Turin, 2003, 212; Croxatto, G.C., *Diritto internazionale tributario*, in *Dig. disc. priv., sez. comm.*, Turin, 1989, vol. IV, 643.

renounce the possibility to levy taxes on the same taxpayer or the same item of income. Provided that, as it will be further discussed, international law does not seem to entail a general prohibition of this kind of "proliferation of tax burdens", a tax imposed by a state through its sovereign powers might very well go to the detriment of another state or of another state's citizen; it follows that such a phenomenon might be the object of a certain level of attention in the field of international law, with a consequent hypothetical need to regulate the cases where such a "proliferation" over the same tax elements might occur.

The starting point of theory which is being discussed has been found in the above-mentioned "*Lotus* doctrine", according to which a state can legitimately take into account elements, facts and events that are located or occur outside its national borders (so-called material territoriality). However, such doctrine does not provide any indication as to the hypothetical need, for international law purposes, for the existence of a link between such facts and the territory of the state in order for that state to be able to exercise its legislative tax competence with regards to foreign elements. Nor the above-mentioned doctrine clarifies whether or not such possible hypothetical need constitutes a customary rule or international law or a general principle of international law.

Given that every state operates in the international context where other analogous subjects operate, and since, on a juridical level, their action implies mutual limitations to state powers, the question now is whether or not general international law actually poses limitations to the exercise of the states' taxing powers, obviously aside from all those limitations stemming from international treaties and conventions[63]. In other words, the task is to determine whether or not there are international general (non-conventional) norms positively determining the cases in which a state can avail itself of its taxing powers and, on the other hand, the cases in which a state should refrain from levying taxes[64].

It goes without saying that the problem is inextricably intertwined with the question of identifying the sources of law in the international (tax) context. In fact, as it is generally known, and briefly said, the complex of international law is composed, on one hand, of general rules of law of a customary nature that are the result of a process of

[63] On the limitations to the states' taxing powers deriving from treaty law, see, amongst others, Vitale, M., *Doppia imposizione (diritto internazionale)*, in *Enc. Dir.*, Turin, 1998, vol. XIII, 1007; Croxatto, G.C., *Diritto internazionale tributario*, cited above, 644; Davies, D.R., *Principles of international double taxation relief*, London, 1985, Adonnino, P., *Doppia imposizione*, in *Enc. Giur.*, Turin, 1989, vol. XII, 1989; Fantozzi, A., Vogel, K., *Doppia imposizione internazionale*, in *Dig. disc. priv., sez. comm.*, Turin, 1990, vol. V, 182.

[64] Biscottini, G., *Diritto amministrativo internazionale*, in Balladore Pallieri, G., Morelli, G., Quadri, R. (eds.), *Trattato di diritto internazionale*, Padua, 1964, sec. II, vol. VI; Martha, R.S.J., *The jurisdiction to tax in international law - Theory and practice of legislative fiscal jurisdiction*, cited above.

consolidation of behaviours and conducts of the subjects constituting the players of the international community and, on the other hand, of law derived from (bilateral or multilateral) treaties and conventions entered into by the states. Needless to say that, while customary international law is binding to all states, conventional international law (treaty law) is only binding with regards to the states that have entered into such agreements[65]. Alongside these "positive" sources of law, a certain degree of attention has been paid to a more "general" - and some say too general - source: the general principles of law recognised by states.

3.1. Is there a "general principle" of tax territoriality in international law?

International law principles are listed by Article 38 of the Statute of the International Court of Justice amongst the sources of international law, together with treaties and customary rules, and are defined as "*the general principles of law recognised by civilised nations*". In other terms, international principles of law are (or are supposed to be) the international equivalent of general "constitutional" principles embedded in the legal orders of the single states and applicable therein, which rise to international relevance if are shared by a considerable number of states. Therefore, in order for a general principle of domestic law to be recognised and applicable in the international legal order, it must be present in the majority of the single states' legal orders and must also be considered by the states themselves as applicable not only domestically, but also transnationally.

This view is essentially based on the assumption that the international legal order, like all other legal orders, is, or at least should be, characterised by principles that are hierarchically superior to customary and conventional law.

Starting from this definition, some authors[66] have argued, with regards to the field of international tax law, in favour of the existence of an international principle[67] of territoriality generally accepted by states. In the words of those authors, such a principle would constitute a sort of "constitutional international law principle" acting as a

[65] With regards to tax law, it must be specified that Italian scholars have traditionally distinguished between "*diritto internazionale tributario*" and "*diritto tributario internazionale*", the first being constituted of all rules with an international source (both of a customary or conventional nature) and concerning the exercise of taxing powers by the states, and the second being made of all domestic rules related to aspects of taxation which go beyond national borders. On the point, see Croxatto, G.C., *Diritto internazionale tributario*, cited above, 641; Udina, M., *Il diritto internazionale tributario*, cited above.

[66] Amongst which, for example, as far as traditional Italian doctrine is concerned, see Udina, M., *Il diritto internazionale tributario*, Padua, 1949, 83.

[67] For a definition of what constitutes an international general principle, see, Gaja, G., *Principi generali del diritto (diritto internazionale)*, in *Enc. Dir.*, Turin, 1989, vol. XXXV, 533.

limitation to the sovereign powers of the states, starting from the presupposition that the international legal order essentially revolves around the different legal orders of the different states, which have to coexist and, therefore, must mutually recognise their prerogatives and limits.

That being stated, scholars dissent, however, on the interpretation and the extension to be given to this hypothetical general "constitutional" principle of territoriality, which has traditionally been interpreted according to two different meanings[68].

In a stricter and more "practical" sense, an hypothetical international law principle of territoriality would entail the limitation of the scope of application of the state's taxing powers only to those particular cases of facts, circumstances, events or, more in general, sources of income located within its territory. This interpretation of the principle at issue, which is the traditional position advocated by German authors, could be defined as "territoriality in an objective sense"[69]. According to this theory, the principle pursuant to which a state can levy tax only on the facts or persons that are subject to its preeminent power or, in other words, to its (territorial or functional) sovereignty constitutes the fundamental rule in the field of international taxation and a sort of *a priori* principle of international law[70].

On the other hand, different authors, both European and American, have opted for a broader interpretation of the meaning of the principle of territoriality in the context of international law, stating that such principle would allow states to tax their citizens even though deprived of any other personal or objective connections to the territory of the state for the mere and simple fact of being their citizens (or nationals or residents)[71]. Adopting this theory would amount to embracing an interpretation of territoriality in a "subjective sense".

Both interpretations of the principle of territoriality seem to support the theory according to which, in order to exercise their taxing powers, states would need a connecting factor, a link between their legal order and the taxpayer. This connecting factor would exist when the taxpayer can be considered as being subject either to the

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[68] Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 319.

[69] This definition has been used, amongst others, by Sacchetto (see Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 319), and, before him, by Bühler (see Bühler, O., *Internationales Steuerrecht und Internationales Privatrecht*, Amsterdam, 1960, as quoted by Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 319).

[70] The theory is clearly expressed in Martha, R.S.J., *The jurisdiction to tax in international law - Theory and practice of legislative fiscal jurisdiction*, cited above.

[71] This interpretation of the principle of territoriality has been traditionally advocated, for example, by Udina, M., *Il diritto internazionale tributario*, cited above, 83; Martha, R.S.J., *The jurisdiction to tax in international law - Theory and practice of legislative fiscal jurisdiction*, cited above, *passim*; Vanoni, E., *Natura ed interpretazione delle leggi tributarie*, in Forte, F., Longobardi, C. (eds.), *Opere Giuridiche*, Milan, 1961, vol. I, 84; Mann, F.A., *Studies in international law*, Oxford, 1973, 97.

state's "personal sovereignty" (territoriality in a "subjective sense"; e.g., when the taxpayer is a citizen of the state) or to the state's "territorial sovereignty" (territoriality in an "objective sense"). There is no need to say that, in case of exercise of "personal sovereignty" on the part of the state, the latter can levy taxes on its citizens even in case they are located, reside, have their seat or operate outside its territory, i.e. outside the scope of spatial validity of the national legal order. On the other hand, aliens, who are not the objects of the state's "personal sovereignty", would be subject to its taxing powers only if, when and insofar as they are somehow related to the scope of validity (end enforceability) of its tax laws.

However, irrespective of which of the two meanings of "territoriality" described above (either subjective or objective) one chooses to adhere to, both arguments are essentially based on the assumption of the existence of a general consolidated principle of international tax law according to which, in case the fundamental elements of a fact, circumstance or event that is fiscally relevant are linked to different legal orders, it is legitimate for the state (or the states) to whose territory (or territories) such elements are connected to levy tax on that fact, circumstance or event[72]. In other words, according to the mentioned authors, a general principle of international tax law would exist by virtue of which states can tax income or other fiscally relevant elements as far as those income or elements are somehow (subjectively or objectively) linked with their territory.

The same theory has also received a partially different formulation, based on the central role of the general mutual recognition, amongst states, of other state's sovereignty. From this perspective, levying taxes on a situation or an event which lacks any sort of link (subjective or objective) to the territory of the taxing state would amount to a violation of another state's sovereignty and, therefore, to a breach of international law[73-74]. According to the proponents of this theory, the existence of such a principle would also find comfort in the recognised international law principle according to which a state cannot impose or ask a foreigner to do something that is not sufficiently justified by an existing link between such foreigner and the state[75].

In different words, it has been theorised that state powers in taxing foreigners should be limited when taxing subjects which have no point of contact with the state itself or its legal order, which essentially means subjects that elude the scope within

[72] Udina, M., *Il diritto internazionale tributario*, cited above, 66.
[73] Micheli, G.A., *Corso di diritto tributario*, Turin, 1989.
[74] Some authors have highlighted that the use of the concept of "sovereignty" in order to justify the thesis of a limited taxing power of the state in the international context is quite improper and that such position should be grounded not on a point of sovereignty, but rather on a point of international law and order.
[75] Conforti, B., *Diritto internazionale*, cited above, 201.

which the sovereign power of the state can be enforced. This thesis has been justified by the general statement according to which it would not be possible to ensure the respect and effectiveness of each state's sovereignty if all states did not recognise the fundamental freedom and equality of all states on the international arena[76].

These have been the statements on a purely theoretical level, asserting the existence of a general principle of territoriality of taxation, i.e. a general principle by virtue of which states should not levy taxes on foreign elements (objects or persons) in absence of a link or connecting factors between them and such elements.

However, these assumptions have been the target of much criticism.

There is, in fact, a fundamental point to consider, which is connected to the definition of what can constitute a "general principle of law recognised by civilised nations" for the purposes of international law.

We have observed above that a general principle in the context of international law is, ultimately, nothing more a "constitutional" principle that is common to the national systems of the majority of civilised nations and recognised as such for merely domestic purposes by single countries. In other words, it is the fact that a principle is embedded in many domestic (constitutional) systems that may lead such a principle to become relevant as a source of international law.

That being stated, it certainly does not seem possible to assert that the constitutional systems of the majority of "civilised states" envisages the recognition of (the binding value of) a principle of tax territoriality. Especially since we have to face the fact that, in practice, many states tend not to limit their fiscal claims only to elements, facts, income or events linked or somehow connected to their territory[77]. This is partly due to the effects of the process that led to an undoubted de-materialisation of income and assets in general, combined with the states' purpose of fighting international tax evasion or tax avoidance as much as possible.

Furthermore, justifying the right for a state to levy taxes on foreign elements, persons, things or events if they have an effective link to that state's territory with reference to the concept of "sovereignty" does not seem to be entirely correct. Aside from the fact that the concept of "sovereignty" appears not to have received an exhaustive and unanimous definition yet, one should also reflect on the fact that, if sovereignty might very well justify the right of every state not to suffer any direct

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[76] Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 321, and the authors cited therein, amongst which see, especially, Luzzato, R., *Stati stranieri e giurisdizione nazionale*, Milan, 1967.

[77] This point will be further developed in the following pages of the present research and, especially, in Chapter III.

interference in its territory (or, better, in the exercise of its sovereign power over its territory) from any other state, that concept does not seem to be able to in any way imply the right of every state to include within the scope of its taxing powers (and, in general, of its activity) elements that are "foreign" and that, therefore, would have to be considered as being part of another state's territory.

Furthermore, it may not be easy to automatically apply the above-mentioned international law principle according to which a state should not ask a foreigner to do something that is not sufficiently justified by an existing link between such foreigner and the state itself to the field of tax law[78].

Some of the scholars who have dealt with the question at issue have also tried to justify the definition and the existence of the principle of territoriality as a general principle of international law by referring to the so-called "principle of effectiveness". Starting from this idea, some have advocated the existence of a general international law principle according to which a state can legitimately expand its taxing powers towards "foreign" elements, circumstances, facts or subjects only insofar as it enjoys the corresponding power to actually and effectively ensure the enforcement of such tax provisions[79].

However, aside from the fact that there does not seem to be any consensus, amongst scholars, on the actual existence and value of a general "principle of effectiveness" as part of international law, this theory, though endorsed by many influential authors especially in past years, seems to create a sort of overlap between the two sides of the same coin that is the principle of territoriality, i.e. between the "material" aspect and the "formal" aspect of territoriality. Adopting this theory would essentially mean linking the legitimacy of a state's choices in the determination of its tax base to the actual possibility for that state to enforce its tax provisions in the future. Such an assertion would imply that, from an international law perspective, a state is allowed to do whatever it has the power to actually attain, which would not be incorrect from a

[78] Especially if we think to certain specific tax rules embedded in many states' tax systems and which seem to be consistently deprived of such effective link. As far as Italy is concerned, an example may be the rule by way of which a subject is considered as "resident" in Italy based on the simple registration in the list of the population ("Anagrafe"), with all consequences on the tax liability of that subject, who will be taxed in Italy on his worldwide income.

[79] This theory has been supported, for example, in Italy, by Micheli, G.A., *Corso di diritto tributario*, cited above, 96; Micheli, G.A., *Problemi attuali di diritto tirbutario nei rapporti internazionali*, in Dir. Prat. Trib., 1965, 1, 222; Lupi, R., *Territorialità*, cited above, 2; Manganelli, A., *Territorialità dell'imposta*, cited above, 369; Tinelli, G., *Istituzioni di diritto tributario*, Padua, 2013, 117. On the international level, similar opinions have been voiced by Arnold, B.J., *Tax discrimination against aliens, non-residents and foreign activities: Canada, Australia, New Zealand, the United Kingdom and the United States*, Toronto, 1991, 7; Qureshi, A.H., *The freedom of a state to legislate in fiscal matters and international law*, in Bulletin of International Fiscal Documentation, 1987, 1, 14; Vann, R., *International aspects of income tax*, in Thuronyi, V. (ed.), *Tax law design and drafting*, Washington, 1998, vol. II, 718.

purely domestic point of view, but would be highly unsatisfactory in the field of international law.

Furthermore, it must also be noted that the problem connected to the actual enforcement of tax laws abroad and of the collection of taxes in foreign territories has, nowadays, been, at least on a theoretical level, partially solved by means of mutual agreements between states[80], making it even more complicated to trace the line between what a state can and cannot do in terms of taxing foreign income (or other foreign elements) based on the above-mentioned "principle of effectiveness"[81].

In light of all of the above, the theory advocating the existence of an international law principle establishing the need for a reasonable and genuine link between the element on which tax is levied and the territory of the state levying the tax has been subjected to considerable criticism and does not seem entirely acceptable.

3.2. Tax territoriality as an international customary rule?

Acknowledging the difficulty not only in defining "territoriality" as an international law principle, but even in defining what an "international law principle" is or should be[82], some scholars have endorsed a theory according to which the principle of territoriality should be considered as the object of an international customary rule.

Article 38 of the Statute of the International Court of Justice defines customary law, amongst the sources of international law, as "*international custom, as evidence of a general practice accepted as law*". In short, international customary rules are generally defined by the coexistence of two different elements: an "objective" element, i.e. the constant repetition by states of the same behaviour in the same (or in comparable) circumstances (*diuturnitas*), and a "subjective" element, i.e. the belief that a certain behaviour corresponds to a juridical obligation on the part of the states and that said

[80] The OECD Model Convention for the prevention of double taxation dedicates two articles to the topic, namely Article 26 (exchange of information) and Article 27 (mutual assistance in the recovery of taxes). At the European Union level, Council Directive 2011/16/EU of 15th February 2011 concerning administrative cooperation in the fiscal field aims at expanding, especially as far as exchange of information is concerned, the scope of application of the previous EU provision on the point (Directive 77/799/EEC). One should also mention the Council of Europe and OECD Multilateral Convention regarding mutual assistance in tax matters and Directive 2010/24/EU on the mutual assistance between Member States in the recovery of tax credits.

[81] Maisto, G., *Brevi riflessioni sulla evoluzione del concetto di 'genuine link' ai fini della territorialità dell'imposizione tributaria tra diritto internazionale generale e diritto dell'Unione Europea*, cited above.

[82] According to influential authors, in fact, accepting the existence of international "constitutional" principles (besides the traditional "*pacta sunt servanda*" and "*consuetudo est servanda*") would imply that international law would be left to the will of the international forces contingently dominating in the international arena, with a consequent proliferation of principles that might possibly also justify forms of abuse dictated by dominant states in the context of the relationships in the international community. This is the opinion, for example, voiced in Conforti, B., *Diritto internazionale*, cited above, 54.

obligation is shared and complied with by all other members of the international community (*opinio iuris ac necessitatis*)[83].

The authors arguing that tax territoriality should be considered as part of customary international (tax) law[84] have generally reached such conclusion starting from the assumption that most countries in the international context would arguably shape or tend to shape their tax systems according to criteria and parameters of a territorial nature. In other words, according to this vision, states would essentially conform to a general common behaviour imposed by customary obligations with regards to international "tax competence", thus restraining from including foreign elements, facts, circumstances or subjects within their tax bases and from expanding the scope of application of their tax provisions beyond their borders.

However, in order to argue for the existence of an international customary law, it is necessary to demonstrate that states adhere to such customary law because they believe it to be compulsory and binding upon them. In other words, in order for a practice generally followed by states to rise to the level of (international) customary law, states need to be convinced that any behaviour that moves away from that general practice would amount to a breach of an obligation established by international law[85].

This simple assumption seems to be enough to deprive the opinion considering the principle of territoriality as embedded in international customary law of all of its strength.

It has been convincingly argued, in fact, that states tend to establish limits to the extension of their taxing powers beyond their territory not by virtue of a general belief that doing the opposite would result in a breach of international law, but rather in light of contingent and incidental reasons of an eminently political nature[86]. Furthermore, the

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[83] It has been correctly highlighted that this second element should not be found through a sort of "psychological analysis" of state behaviour and on the reasons that led a certain state to act in a certain way, but rather in the actual events and behaviours repeating themselves. Starting from this assumption, some influential scholars in the field of international law have advocated a view according to which, given the difficulty to demonstrate the element of the *opinio iuris*, in order to demonstrate the existence of an international customary rule the simple element of the *diuturnitas* might be enough, as a starting point from which to presume the existence of an *opinio iuris*. On this theory, see, for instance, Conforti, B., *Diritto internazionale*, Naples, 2013, 33. For a definition of "customary law" in the context of international law, see Ziccardi, P., *Consuetudine (diritto internazionale)*, in *Enciclopedia del Diritto*, vol. IX, Milan, 1992, 476.

[84] Amongst which, see, for example, as far as Italian doctrine is concerned, Vanoni, E., *Natura ed interpretazione delle leggi tributarie*, cited above; Gaffuri, A.M., *La tassazione dei redditi d'impresa prodotti all'estero. Principi generali*, cited above, 333, and the authors cited therein; Guggenheim, P., *L'imposition des successions en droit international et le probléme de la double imposition*, Geneva, 1928, 8.

[85] Chrétién, M., *Á la rechèrche du droit international fiscal commun*, Sirey, 1959, 234; Croxatto, G.C., *Diritto internazionale tributario*, cited above, 451; Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 327.

[86] Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 327; Steve, S., *Sulla tutela internazionale della pretesa tributaria*, in Riv. Dir. Fin., 1940, 1, 241; Marino, G., *L'unificazione del diritto tributario: tassazione mondiale verso tassazione territoriale*, in VV.AA., *Studi in onore di Victor Uckmar*, Padua, 1997, vol. II, 872. The Italian Constitutional Court has, for example, stated that the state is generally free, in absence of any international or supranational rule to the contrary, to connect a tax debt to any event having an economic consistency, with the only limit of the

behaviour of the states in shaping their cross-border tax base often directly contradicts the assumptions based on territoriality, or rather on a strict interpretation of territoriality "in an objective sense", with states expanding their tax bases even beyond their borders in order to attain purposes which, once again, are essentially political.

Even if one could actually demonstrate, in practical terms, the existence of an uniform behaviour on the part of the states in defining their cross-border tax bases with reference to criteria that could be defined as "territorial", this hypothetical uniform behaviour would not prove anything more than the fact that states, in shaping their tax systems, are constantly searching for a connection between the tax subject and the state's territory or between the tax object and the state's territory. This would not *per se* be enough, in fact, to demonstrate that such restraint on the part of the states is considered by the states themselves as "compulsory" by virtue of an obligation posed by international law and not just as the result of a mere consolidated practice[87].

Acknowledging all of the above has led numerous international tax scholars to denying not only the possibility to consider the concept of "territoriality" as part of international customary law[88], but also to seriously doubt the very existence of customary international rules in the field of tax law[89].

However, some influential authors have still, and also recently, advocated the existence of an international common tax regime ruled by customary international law[90]. Nonetheless, it is clear from a closer look to the reasons behind these theories that the

prohibition of merely arbitrary tax provisions. On the point, see De Mita, E., *Interesse fiscale e tutela del contribuente*, Milan, 2000, 182, and the Constitutional Court's judgement cited therein, amongst which especially Constitutional Court, May 4 1995, n. 143, in *Boll. Trib.* 1995, 873; Constitutional Court, June 14 2002, n. 250, in *Giur. Cost.* 2002, 3; Constitutional Court, July 25 2002, n. 399, in *Giur. Cost.* 2002, 4.

[87] Biscottini, G., *Diritto amministrativo internazionale*, cited above, 365.

[88] Most Italian and international scholars are essentially unanimous in denying the existence of an international customary rule embedding the principle of territoriality. On the point, see, for example, Manganelli, A., *Territorialità dell'imposta*, cited above, 369; Udina, M., *Trattato di diritto internazionale*, cited above; Uckmar, V., *La tassazione degli stranieri in Italia*, cited above, 50; Van Raad, K., *Non discrimination in international tax law*, The Hague, 1986, 25; Forry, J.I., *Differences in tax treatment of foreign investors: domestic subsidiaries and domestic branches*, The Hague, 1984, 20; Tarigo, P., *Capacità contributiva e doppio d'imposta internazionale*, in Riv. Dir. Trib., 2011, 1, 554; Qureshi, A.H., *The freedom of a state to legislate in fiscal matters and international law*, cited above, 14; Qureshi, A.H., *The public international law of taxation. Text, cases and materials*, London, 1994, 22. *Contra*, see, amonst others, Lupi, R., *Territorialità del tributo*, cited above, who quotes several influential scholars advocating the theory of the existence of an international customary rule in connection to the principle of non-discrimination; Maisto, G., *Brevi riflessioni sulla evoluzione del concetto di 'genuine link' ai fini dell aterritorialità dell'imposizione tributaria tra diritto internazionale generale e diritto dell'Unione Europea*, cited above.

[89] Some doubts have recently been voiced even with regards to the international tax treatment of diplomatic agents. More specifically, the traditional view (for example, Conforti, B., *Diritto internazionale*, cited above, 216) was that, according to a well-founded international customary rule, states refrain from taxing the income received by another state's diplomatic agents within their territory, if said income is related to the exercise of public functions on the part of such agents. However, some authors have argued that the exemption of such income is not granted pursuant to an international customary rule, but rather by virtue of a mere "international courtesy". Of this opinion, Udina, M., *Diritto internazionale tributario*, cited above, 157; Croxatto, G., *Diritto internazionale tributario*, cited above, 645.

[90] Avi-Yonah, R.S., *International tax as international law. An analysis of the international tax regime*, Cambridge, 2007, *passim*.

claim that an international tax regime exists rests mainly on the analysis of the current bilateral treaty network, which is made of conventions that are remarkably similar to one another, being based on the same Models (either the OECD Model or the UN Model)[91]. Starting from this (empirical) assumption, authors advocating the existence of such a regime essentially state that, since in most countries treaties enjoy a higher status than domestic law and since treaties typically override contrary domestic provisions, it would follow that countries are bound by treaty to behave in certain ways as far as the exercise of their taxing powers on foreign elements is concerned and cannot enact any legislation to the contrary. Consequently, according to these theories, international agreements would be able to create law for all states parties thereto and may lead to the creation of customary international law when such agreements are intended for adherence by states generally and are in fact widely accepted.

Briefly said, the above-mentioned scholars argue that the network of bilateral tax treaties that are largely similar in policy constitutes an international tax regime, with underlying common principles such as the so-called "single tax principle" and the so-called "benefit principle"[92].

Pursuant to the "single tax principle", income from cross-border transactions should be subject to tax once, i.e. not more but also not less than one: basically, according to the theory that is being discussed, the "single tax principle" amounts to a general rule prohibiting double taxation but also double non-taxation. This view would be in line with the latest developments at OECD level, being that the Commentary to the Model Convention has been recently modified in order to clarify that the purpose of a bilateral tax treaty is not only to prevent international double taxation, but also to avoid that certain cross-border items of income elude taxation at a global level[93].

Furthermore, as far as the "benefits principle" is concerned, such principle basically allocates the right to tax active business income primarily to the source

[91] It has also been argued that the existence of an uniform practice on the part of the states in drafting their bilateral tax conventions, referring either to the OECD or the UN Model Conventions, would be the demonstration of a "particular" or "specific" customary rule embedding the principle of territoriality in the sense of the need for a state to levy taxes only in presence of an effective link between the territory and the income, where a "particular" or "specific" customary rule would be a customary rule formed and applicable only amongst a certain number of states. Of this opinion, Gaffuri, A.M., *La tassazione dei redditi d'impresa prodotti all'estero. Principi generali*, cited above, 342; on similar positions, Melis, G., *Vincoli internazionali e norma tributaria interna*, Rome, 2005, 1104. This thesis, however, would essentially lead to granting binding effects to Model Conventions such as those drafted by the OECD and the UN, which does not seem an acceptable result, given, amongst other elements, the number of reservations expressed by states to the provisions of such Model Conventions and that the OECD and the UN themselves explicitly recognise the non-binding nature of those Models.

[92] Avi-Yonah, R.S., *International tax as international law. An analysis of the international tax regime*, cited above, 3.

[93] As it is known, a considerably higher degree of attention is being paid nowadays by the OECD to the problems of evasion and elusion (e.g., the Base Erosion and Profit Shifting project's aim was for states to work together to find possible solutions to traditional problems of international avoidance in the modern context).

jurisdiction and the right to tax passive investment income primarily to the residence jurisdiction[94].

However, this theory shows many points of weakness.

First of all, the simple fact that, *rebus sic stantibus*, in the current situation where the "elusion alert" is particularly high, states recognise that double taxation conventions should play this sort of "double role" does not necessarily make the underlying statement a general principle of international law or an international customary rule. In fact, even if it could be theoretically possible to find a certain level of *diuturnitas* in the behaviour of the states, the second element of *opinio juris ac necessitatis* is evidently lacking, being this behaviour of the state essentially depending on mere political and economic reasons: in other words, one can hardly assume that states fight tax avoidance and/or tax evasion and to try to prevent a certain income from eluding taxation at the global level because they believe that not doing so would constitute an infringement of international obligations.

Double taxation conventions are bilateral international instruments based on reciprocity, which makes them genetically unable to be any demonstration of the existence of a customary rule. In other words, the need for states to explicitly establish provisions to regulate the exercise of their taxing powers on a bilateral basis according to territorial criteria could be seen *per se* as proof of the absence of any customary binding rule establishing a duty to conform to territorial criteria in the taxation of cross-border income[95].

It has been correctly noted that the mere "sum" of the existing bilateral tax treaties is not sufficient in order to give rise to an international customary rule, being it necessary to distinguish between the simple practice generally followed by states and what states do because they are convinced that not doing it would lead to a breach of international law[96]. Especially if we consider, as it has been correctly highlighted, that tax treaties are by their own nature bilateral, nothing more than instruments of economic policies and tools for international players to realise a compromise between the

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[94] For a brief overview of the benefit principle and its interplay with the allocation of taxing powers and principles such as taxation according to ability to pay, see Lang, J., *La tassazione delle imprese nella competizione internazionale*, in Riv. dir. fin., 2012, 2, 237.

[95] According to the mainstream opinion of international law scholars, treaty law can be considered as proof of the existence of a customary rule only with regards to multilateral conventions, which are quite rare in the field of tax law. On the contrary, many proposals have been promoted by international organisation in order to stipulate a treaty amongst more than two states to prevent international double taxation, which, once again, demonstrates the inexistence of any customary rule embedding the principle of tax territoriality in international law.

[96] Melis, G., *Vincoli internazionali e norma tributaria interna*, cited above. However, the author seems to contradict himself in the prosecution of his work when he states that, nonetheless, the uniform tax treaty practice at the international level with regards to some more specific concepts (such as the concept of permanent establishment or the arm's length principle in the context of transfer pricing) could actually give rise to a binding customary rule in the field of tax law with regards to such more specific concepts.

commercial and economic needs of two states and to protect their tax bases and their entrepreneurs and capital exporters/importers[97].

Furthermore, the scope of application of double taxation conventions is almost exclusively limited to income taxation, which, if we were to embrace the above-mentioned thesis, would result in the quite peculiar statement that a customary rule prescribing territorial taxation would be applicable to only some taxes and not to other taxes[98].

Moreover, bilateral tax treaties signed by states in the international practice are inspired essentially to two very different models (the OECD Model Conventions and the UN Model Convention[99]), which is another proof of the impossibility to derive the existence of a customary rule from the international law practice of the states, since the differences amongst bilateral treaties signed by countries might be sufficient to exclude not only the element of the existence of an "*opinio juris ac necessitatis*", but also the requirement of "*diuturnitas*". Otherwise, we would have to accept the existence of an "international" customary rule binding only to some states and not to other states, since, for example, some Latin American countries do not recognise the OECD Convention as a model, having resorted to another Model altogether[100], and also Northern-European states have come up with their own multilateral convention[101]. Furthermore, such a theory seems even less convincing if we consider that many states have expressed reservations to both the OECD and the UN Model Conventions (and to their respective Commentaries), thus giving rise to many differences that radically exclude the presence of an "*opinio juris*", and that, furthermore, some states expressly reserve themselves the right, in specific cases, to override bilateral tax treaties, or certain provisions of the tax treaties, and to apply their domestic provisions instead[102].

It must be clear, however, that what has been said above does not amount to denying the undoubted relevance played, in the international tax law practice, by the

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[97] Sacchetto, C., *Il diritto internazionale tributario tra norme del sistema costituzionale italiano, effettività ed utopia*, cited above, 314.

[98] Maisto, G., *Brevi riflessioni sulla evoluzione del concetto di 'genuine link' ai fini dell aterritorialità dell'imposizione tributaria tra diritto internazionale generale e diritto dell'Unione Europea*, cited above.

[99] We will dwell more deeply on the two models and their influence in the international allocation of states' taxing powers in the following pages of the research.

[100] I.e. the so-called "Andean Pact", which, though of very limited application, is characterised by the employment of principles symmetrically opposed to those inspiring the OECD Model Convention, with a large implementation of territorial taxation, to the point that such Model does not entail any rule for the determination of the taxpayer's residence in one of the contracting states. On the point, see Jaramillo, T., *La fiscalidad internacional en la comunidad andina*, in Uckmar, V. (ed.), *Corso di diritto tributario*, Milan, 1999, 805.

[101] The Nordic Convention on Income and Capital, entered into by Denmark, Finland, Iceland, Norway and Sweden, which was concluded in 1983 and replaced in 1987, 1989 and 1996, even though this multilateral treaty follows the OECD Model very closely.

[102] For example, Article 1 of the United States Model Convention expressly provides a reservation to override tax treaties in favour of domestic rules towards U.S. citizens.

OECD and UN Model Conventions and by their respective Commentaries, whose influential contribution has most certainly rendered the implementation of international tax law more uniform and homogeneous and serves, in practice, as a guidance for the interpretation, by national judges, of international tax law provisions and concepts. Starting from the acknowledgment of the influential role of such Models some authors have even defined them as a "quasi-source" of international law or, better, as sources of soft law[103]. However, this does not automatically imply the possibility to define the practical criteria enshrined in such Models as the content of a "customary rule", for all the reasons explained above.

The debate on the problems at issue has also been influenced, in part, by the questions concerning the interactions between international tax treatment of foreign income and equality. In fact, once we acknowledge the possibility for states to tax foreigners in a different way depending on their state of residence, this assertion amounts to denying the existence of an obligation to treat foreigners and citizens in an equal way as far as taxation is concerned, which means denying the existence of a general principle of equality in international law or, at least, the existence of a principle of equality in international law with regards to taxation[104].

One should also bear in mind that this conclusion is somehow inevitable if we consider that it seems practically impossible to implement a general principle of equality in international taxation if, as it has been highlighted above, the situation of the two "categories" of taxpayers concerned, foreigners and citizens (i.e. non-residents and residents) cannot be compared. And that is because, first of all, while the state encounters practical limits and difficulties in enforcing its tax provisions on foreigners residing in a foreign territory, such limits and difficulties do not apply as far as taxation of the state's citizens is concerned[105].

The answer is not changed by the fact that several double taxation conventions signed by states (and model conventions as well) entail provisions aimed at preventing discrimination based on nationality, by way of which citizens of a contracting state cannot be subject in the other contracting state to any tax (or administrative

[103] Sacchetto, C., *Il diritto internazionale tributario tra norme del sistema costituzionale italiano, effettività ed utopia*, cited above, 316.

[104] Of this opinion, Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 58; Croxatto, G.C., *Diritto internazionale tributario*, cited above, 644; Conforti, B., *Diritto internazionale*, cited above, 391; Uckmar, V., *La tassazione degli stranieri in Italia*, cited above, 58; Albrecht, A.R., *The taxation of aliens under international law*, cited above, 171.

[105] As highlighted by Baggio, this hypothetical "international principle of equality" would suffer many breaches by states which regularly grant a more favourable tax regime to foreign enterprises than the one reserved to their national business in order to improve their level of attractiveness towards foreign investments; see Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 58.

encumbrance) that is different or more burdensome then those imposed on that other state's citizens[106]. On the contrary, it has been correctly stated that such conventional provisions are not in any way proof of the existence of a customary international rule enshrining a hypothetical principle of equality, but rather demonstrate the exact opposite, i.e. the fact that such a customary rule does not exist, being it the result of specific agreements between states[107].

Therefore, coming to a partial conclusion, if, on one hand, it may prove difficult, in light of all of the above, to identify the principle of territoriality as a general principle of international law or even as a customary rule of international law[108], it is also true, on the other hand, that the international law perspective does not necessarily lead to questioning one of the implications of the principle of territoriality from a purely domestic perspective, that is to say the assumption that the mere legislative activity of the state does not *per se* imply an extraterritorial exercise of the state's taxing powers[109]. In other words, there does not seem to be any international law rule or international law principle which has the effect of limiting the states' freedom and independence, at least potentially, in establishing their domestic tax provisions and, more specifically, which elements should be considered as proper fiscal objects[110].

The only limit with this regard would seem to lie in the merely political analysis of the practical or "diplomatic" opportunity and measure of the expansion of the tax base beyond national borders, which usually leads states to refraining from including within their tax bases "foreign" elements that do not have any reasonable or effective

[106] Tax treaties usually provide for a non-discrimination clause preventing a contracting state from imposing citizens from the other contracting state a tax treatment that could be more burdensome than the one reserved to its own citizens. The same applies to the treatment of corporations or enterprises directly or indirectly controlled by residents of the other contracting state and also to the tax treatment of permanent establishments. These sorts of provisions are enshrined, as far as the OECD Model Convention is concerned, in Article 24.

[107] Croxatto, G.C., *Diritto internazionale tributario*, cited above, 644. Several authors, however, do not exclude that a customary international law preventing discrimination in international taxation could ever see the light, given the considerable amount of examples in state practice. On the point, see Udina, M., *Il diritto internazionale tributario*, cited above, 89.

[108] It has been stated that the international tax system does not know, by its own nature, any sort of *jus publicum*, being it the mere result of a network of bilateral double taxation conventions which do not go beyond the purpose to provide a contigent solution to practical problems. According to this view, conventions are the only way states can consciuosly create international law (see, for example, Dixon, M., *Textbook on international law*, London, 1993, 32). On the point, Sacchetto, C., *Il diritto internazionale tributario tra norme del sistema costituzionale italiano, effettività ed utopia*, cited above, 314.

[109] Sacchetto, C., *Tutela all'estero dei crediti tributari dello Stato*, Padua, 1978, 96.

[110] The idea that the state is potentially free to regulate any fact, circumstance or event with regards to any subject irrespective of where that fact takes place or where the subject resides has been defined as a corollary of one of the traditional principles of international law, i.e. the principle of universality of the legal order. On the point, see Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 325. Furthermore, according to Gaffuri, A.M., *La tassazione dei redditi d'impresa prodotti all'estero. Principi generali*, cited above, 313, income produced outside of a state's national borders is as much indicative of an increase in economic resources as income produced within domestic territory and, as far as "natural" characteristics are concerned, foreign income is not inherently different from domestic-source income; therefore, there would be no reason for a state not to levy tax on foreign income based exclusively on its location.

link to their authority[111]. But, again, this kind of pondering does not seem to find its source in any international law binding rule (either of a normative or a customary nature) or general principle, but only in evaluations of a strictly political nature[112]. The same, on the other hand, as it will be shown in the following pages of the present work, cannot be said with regards to the effects of the European Union's legal order on the Member States' taxing powers.

In other words, if, from an international law perspective, it might be accepted, in light of all of the above, that there are some limits to the states' taxing powers and to the extension of such powers beyond national borders, such limits, given the current situation of the international practice of the states and given the undoubted difficulty, *rebus sic stantibus*, of tracing any underlying rule or principle on the point in the field of international law, should be qualified as no more than the result of the exercise of a self-limiting restraint on the part of the states[113].

It also follows that no internationally binding rule or principle can be considered as effectively able to prevent the inevitable consequence of this free and independent parallel exercise of taxing powers on the part of the states, i.e. international double taxation, with the consequent (practical) need for states to resort to bilateral tax conventions[114].

It should also be highlighted that, according to some authors, even if it could actually be argued that international law entails a rule pursuant to which states may exercise their taxing powers on taxpayers and/or items of income only if there is a

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[111] Mann, F.A., *The doctrine of jurisdiction in international law*, cited above, 96.

[112] Several authors have highlighted that bilateral tax treaties and the allocation of taxing powers they realise do not follow any criterion based on equity or rationality, but rather depend on the political and commercial strength of each state, which also exercise a sort of "peer-pressure" leading to a substantial uniformation of states' tax systems. Lang, for example, has stated that national legislation does not (and cannot) nowadays act in an autonomous and independent way in the context of fiscal competition, being it, on the contrary, subject to a "pressure to conform", as a justification of a systematic change in the field of taxation of enterprises and of capital investment. According to the Author, even the United States had to give in to this pressure: see Lang, J., *La tassazione delle imprese nella competizione internazionale*, cited above, 237. Of this opinion, see also Knoll, M.S., *The corporate income tax and the competitiveness of U.S. industries*, in Tax Law Review, 2010, 771; Owens, J., *Taxation within a context of economic globalisation*, in Bulletin of International Taxation, 1998, 290; Lodin, S., Lodin, O., *International tax issues in a rapidly changing world*, in Bulletin of International Taxation, 2001, 1; Sacchetto, C., *Il diritto internazionale tributario tra norme del sistema costituzionale italiano, effettività ed utopia*, cited above, 315.

[113] Steve, S., *Sulla tutela internazionale della pretesa tributaria*, cited above, 243; Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 327. *Contra*, see Manganelli, A., *Territorialità dell'imposta*, cited above, 369, where the Author asserts that, given the circumstance that states, in practice, levy taxes on elements that are somehow characterised by some kind of link (either subjective or objective) to their territory, the question whether they do so by virtue of an international customary rule or because of a mere "self-restraint" on their part due to political reasons is irrelevant and merely "theoretical", since the practical result would be the same in both cases.

[114] The fact that the exclusive purpose of bilateral tax treaties is to provide a practical solution to contingent problems connected to international double taxation is recognised, for example, also by the Commentary to the OECD Model Convention, which expressly states that the concept of "residence" is relevant for three purposes only: "*a) in determining a convention's personal scope of application; b) in solving cases where double taxation arises in consequence of double residence; c) in solving cases where double taxation arises as a consequence of taxation in the state of residence and in the state of source or situs*" (OECD, *Model Tax Convention on income and on capital - Condensed version*, Paris, 2014, 85).

connection between such elements and the territory of the states, such a rule would not have any practical result. This is because this hypothetical rule would not be able to prevent the exercise of concurring taxing powers by states on the same elements and, therefore, the effects of international double taxation, since an element, a fact or a person which might be fiscally relevant may very well be connected to more than one territory, depending on the kind of connection that is deemed necessary[115].

The conclusion is, therefore, that when a state exercises its tax jurisdiction on the basis of the "principle of territoriality" as it stands in international law, said state has the choice as to the geographical extent of its tax jurisdiction: either said jurisdiction is exercised solely on domestic income or it is exercised also on foreign income, meaning that according to the principle of territoriality, a state is normally at liberty to tax foreign income subject to all limitations provided for by bilateral tax treaties[116].

In other words, pursuant to international law, a state could actually tax a non-resident company or individual without any limitations derived by generally recognised international rules, so that not even a tax imposed on a taxpayer without any significant link (or even any link whatsoever) with the taxing state could not be considered as an infringement of any provision of international law[117]. Therefore, since, according to literature, there is no juridical foundation to any doctrine stating that the taxing power of a state cannot be exercised beyond the taxpayer's assets on that state's territory, theoretically speaking a state could very well tax non-residents' income on a worldwide basis.

According to part of legal doctrine, however, taxing powers need some sort of link to be exercised. It follows that a state could exercise its taxing powers only insofar as the company or the individual taxed is somehow "linked" to the state itself. This link, or nexus, is generally conceived as a "physical" one, so that the company or the individual at issue can be taxed by a state only if it/he/she resides within the territory of that state or has its/his/her abode there and so on. The same authors also state that the link between the taxpayer and the taxing authority is (*rectius*, should be) not only the condition allowing the latter to impose taxes on the taxpayer, but also the measure of the amount of tax that can be levied.

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[115] Croxatto, G., *La imposizione delle imprese con attività internazionale*, cited above, 45; Tarigo, P., *La doppia imposizione giuridica internazionale come fattispecie disciplinata nei trattati bilaterali*, in Riv. dir. trib., 2009, 670. *Contra*, Gaffuri, A.M., *La tassazione dei redditi d'impresa prodotti all'estero. Principi generali*, cited above, 331.

[116] Monsenego, J., *Taxation of foreign business income within the European internal market*, The Hague, 2012, 11.

[117] According to the mainstream literature, "*there is no territorial principle in international law which limits taxation to income arising within the territory to fiscal subjects within the jurisdiction*"; see Qureshi, A.H., *The freedom of a state to legislate in fiscal matters under general international law*, cited above, 16; Greggi, M., *Revisiting Schumacker: the role of limited tax liability in EU law*, in Richelle, I., Schon, W., Traversa, E. (eds.), *Allocating taxing powers within the European Union*, Heidelberg, 2013, 50.

Despite the fact that the same authors advocating the last-mentioned position admit that there are no positive rules or customary principles endorsing their opinions[118], most states recognise, in practical terms, that their taxing powers can be exercised only in presence of a nexus between the individual or the company and their legal system or their territory[119]. In the vast majority of cases, the state where the income has its source also limits its taxes to the ability to pay manifested by an individual or a company in its territory, thus implementing a sort of proportionality rule. Thus, states - source states, to be exact - show, in merely practical terms, an intrinsic self-restraint when dealing with a taxpayer that has got no any kind of link to their territory.

There is also another point to be considered, which is of paramount relevance for the continuation of the present research. Excluding the possibility to define territoriality as embedded in an international customary rule has its consequences on European Union law as well. The Court of Justice of the European Union has, in fact, consistently stated that the Union is bound by international law, including customary international law[120]. Customary international law, therefore, binds the European Union legislature and must be complied with in all European Union actions. It follows that ruling out that territoriality could constitute an internationally binding customary rule excludes the duty for the European Union legislature to comply with it and for the Court of Justice to find the illegitimacy of provisions which are not in line with territoriality.

In light of the above, once we have excluded the possibility to describe territoriality as a principle enshrined in international tax law and as an example of a customary international law, the only possible solution to define territoriality is to go back to its national dimension, defining it as a corollary of national sovereignty, as a inherent character of the state's sovereign powers, also in fiscal matters.

[118] Chrétien, M., *A la recherche du droit international fiscal commun*, cited above.

[119] According to Qureshi (cited above), "*there is indeed a discernible practice of states to base fiscal jurisdiction on certain common reasonable links*", even though the vast differences amongst states' practice on the point prevents from ascertaining the existence of a common principle of international customary law.

[120] The Court held, for example, that "*when it adopts an act, [the European Union] is bound to observe international law in its entirety, including customary international law, which is binding upon the institutions of the European Union*" (Court of Justice of the European Union, 21 December 2011, C-366/10, *Air Transport Association of America and Others v. Secretary of State for Energy and Climate Change*). In the same judgement, the Court has specified that the standard of review for compliance with customary international law on the part of European Union measures is less intense than the standard applicable to verify the compatibility of EU law with international agreements: "*since a principle of customary international law does not have the same degree of precision as a provision of an international agreemtn, judicial review must necessarily be limited to the question whether, in adopting the act in question, the institutions of the European Union made manifest errors of assessment concerning the conditions for applying those principles*".

4. The new face of territoriality as a criterion for the allocation of taxing powers in search of a reasonable and genuine fiscal attachment: worldwide taxation vs. source taxation.

Having established what “fiscal sovereignty” and “fiscal jurisdiction” entail, and having established that, in practice, even in absence of any binding international law rule or principle on the point, states recognise that fiscal jurisdiction should have its own bounds, being it a concept strictly linked to state sovereignty - which is essentially somewhat “limited” in the terms explained above - the question now should be how states establish the limits of their fiscal jurisdiction.

As it has correctly been argued, all studies concerning the territorial scope of application of tax law, even though they have resulted in a rigorous theoretical analysis and description of the problem at national and international level, have left open a considerable number of questions of a practical nature, e.g. the problem of juridical double taxation[121]. Therefore, the attention of the authors has recently shifted to the elaboration of more “technical” principles - or rather criteria - with the purpose to mediate or minimise the prejudicial effects of international double taxation on the efficiency and equity of international taxation.

In other words, assuming that it seems impossible, or at least extremely difficult, in light of what has been said above, to consider territoriality as a “principle” embedded in international law (which would imply recognising its role as a source of law in the international context) or as part of customary international law, and also assuming that, in the national context, talking of territoriality essentially means dealing with problems of definition of the state’s tax base, contemporary studies of the topic at issue tend to focus on an entirely different, more practical and technical, point of view. This change of perspective has been partly justified by the considerable level of attention currently being paid to the problems posed by international (juridical) double taxation and to the consequent need to find ways to prevent them and to ensure the efficiency of transnational trade and the highest possible level of equity of taxation on taxpayers, attempting to minimize as much as possible the prejudicial effects of international double taxation.

As a result, the concept known as “territoriality”, even though still considered as one of the paramount landmarks of international tax law, has undergone a progressive “demotion” of its role, going from being considered a fundamental “principle” of

[121] Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 328.

international tax law[122] to being reduced to a mere "criterion" used by states to guide their economic policies and to allocate their taxing powers over cross-border tax bases, in an attempt to reach a higher level of fiscal neutrality in the context of international trade[123-124]. In other terms, the "decline" of the dogmatic value of the principle of territoriality has led to its rationalisation and technicalisation[125].

Consequently, "territorial taxation" is now synonym to a tax model according to which states only levy taxes on income produced or having its source within their territories or, in other words, on income that is linked to the states' territory in light of an objective connection[126]. This model of taxation, based on an interpretation of territoriality as a criterion, is generally referred to as "source taxation", as opposed to the "worldwide taxation" model, according to which states may tax all income accrued upon their residents, nationals or citizens irrespective of where those income are located or have their source[127].

As far as international tax law is concerned, there are no generally recognised rules according to which a state must tax resident individuals or companies on their worldwide income, while taxing non-resident individuals or companies only on the income they produce within its territory (limited tax liability). However, it has been highlighted that there is a remarkable degree of convergence between tax regimes of developed countries, not only as far as international rules are concerned, but with

[122] If one can actually speak of a real "principle", in light of all that has been said *supra* on the debate concerning territoriality in the national and international context.

[123] Sacchetto, in acknowledging the progressive "evolution" of territoriality from principle to criterion, recognises that this process has been essentially fostered by Anglo-Saxon authors, who are traditionally more focused on empirical and operative aspects of the problem. See, on the point, Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 305.

[124] Looking beyond the borders of tax law, this evolution has been theorised by Kelsen, who essentially stated that all norms are valid "always and everywhere" if limitations to their territorial or temporal validity are not provided by the norms themselves. In other words, possible limitations to the validity of the norms, according to Kelsen, are not to be found in the nature and essence of the norms, but exclusively in the single positive legal order.

[125] As it has been stated by Krüger, territoriality has not lost its central role as an institutional concept in international law, but what has progressivley lost its importance is the institutional element of the principle of territoriality; see Krüger, *Allgemeine Staatslehre*, Stuttgart, 1964, 98, as quoted in Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 328.

[126] According to the *IBFD International Tax Glossary*, the definition of "territoriality" is as follows: "*Term used in the context of international taxation to connote the principle of levying tax only within the territorial jurisdiction of a sovereign tax authority or country. The underlying theory is that no taxes can be levied outside this area without violating the sovereign tax authority of another state. Consequently, both residents and non-residents of a state adopting this principle are only taxed on the income from sources in that country and on property situated in that country. Residents are not normally taxed on any foreign-source income (sometimes, however, subject to anti-avoidance measures). The term may also refer to the principle that a state has the right to tax all persons, property and activity within its borders. The term is also used in a similar way in the context of EU direct taxation, although the precise meaning appears still to be evolving*".

[127] Traditional doctrine has observed that this dichotomy revolves around the two most relevant moments, for tax purposes, in the production of the income, with a higher degree of attention being paid to the initial and final moment of such process: the genesis of the income, its production, which, of course, takes place in the source state, and the final step of the process, i.e. its consumption, whihc is generally performed in the state of residence of whoever receives the income. This view has been voiced, for example, in the 1923 League of Nations report *Sur la double imposition présenté au Comitié financier par MM Bruins, Einaudi, Seligman et Stamp*.

regards to purely domestic tax provisions as well. The need to face similar problems in taxing income has led different jurisdictions with different starting points to reach quite similar results[128].

Despite such a significant convergence in international tax law, important differences remain when comparing domestic tax laws as well as other areas outside the income tax treaty network, the main one being the difference between states adopting worldwide (or "universal") income taxation systems and states following strictly territorial models[129].

Admittedly, the above-mentioned distinction between worldwide and territorial jurisdictions has become more and more blurred with the constant evolution of modern tax systems, aiming, on one hand, at preventing taxpayers from putting in place undue profit shifting measures - thus somewhat expanding their tax jurisdictions beyond the state's physical borders - and, on the other hand, at attracting new investments. It follows that worldwide jurisdictions do not generally tax their residents on all foreign source income[130] and, in practice, source jurisdictions do not limit their taxing powers to domestic income only. For these reasons as well, scholars have highlighted a sort of convergence between the two models[131].

Taking a step back, it should be highlighted that if, on one hand, the source-residence dichotomy lies on a question of legitimacy of taxing powers, the worldwide-territoriality dichotomy relates to the extension of taxing powers, i.e. to the extension of the powers to levy taxes on income derived from cross-border activities[132].

In this new perspective, the central concept is that of "fiscal attachment".

Said concept has the purpose to explain and describe the relationship between the entity holding fiscal jurisdiction (i.e. the state) and the fiscal subject or the object of taxation, thus determining the possibility (again, on a merely practical level, since, on the theoretical level, this possibility for the state seems boundless) for the first to extend its fiscal jurisdiction to the latter. Differently said, the concept of "fiscal attachment" serves to explain the relationship between the holder of fiscal jurisdiction and the fiscal subject

[128] It has been noted, for example, that countries that were initially characterised by a "global" tax system, taxing all income from whatever source derived in the same way, have now incorporated schedular elements, whereas countries (such as the United Kingdom) with a schedular background have largely adopted schedules for "other income" that lead to a global tax base.
[129] This distinction is mirrored in the OECD Model Convention, since, as we will see, it makes provisions, with two alternative articles, in order to allow States to choose which method to prevent juridical double taxation they see as more fit to the structure of their own tax system: a foreign tax credit article for worldwide jurisdictions (Article 23 B of the OECD Model Convention) and an exemption article of territorial jurisdictions (Article 23 A of the OECD Model Convention).
[130] For example, income earned through foreign subsidiaries controlled by residents is not generally taxed by the State of residence of the controlling entity, even though there are several anti-deferral regimes in place.
[131] Avi-Yonah, R. S., Sartori, N., Marian, O., *Global perspectives on income taxation law*, London, 2011, 151.
[132] Sacchetto, C., *L'evoluzione del principio di territorialità e la crisi della tassazione*, cited above, 35.

or object of taxation, determining, according to some, the legality of the exercise of fiscal jurisdiction[133].

Going back to what was said before about the distinction between personal sovereignty and territorial sovereignty, authors generally distinguish between "personal" fiscal attachments and "economic" fiscal attachments. In case the relationship between the state and the fiscal subject is indirect - that is to say when the object of the tax is located in the state exercising fiscal jurisdiction (e.g. property and other sources of income within the taxing state) - the fiscal attachment is deemed to be "economic"[134].

Scholars have traditionally traced a distinction between the different linking criteria based on the elements on which such criteria are founded.

On one hand, some links are defined as "objective", connecting taxing powers to elements located or taking place within the territory of the taxing state, with such presence being seen as a symptom of "economic allegiance": in an extreme simplification of a much more complicated reality, it can be stated that these are the links which are used by a state whose tax system is inspired by the "source principle", which is the paramount benchmark of systems adhering to territorial taxation.

On the other hand, there are some other links, which are defined as "personal" or "subjective links", that are generally based on the taxpayer's residence (as a sort of "social allegiance") - or, anyway, on other similar characteristics, such as the taxpayer's citizenship ("political allegiance")[135] - irrespective of where the income being part of that taxpayer's tax base originates. This is the criterion used by all those states implementing a tax system based on the so-called "worldwide taxation principle".

The concept of fiscal attachment must be complemented by the concept of fiscal liability, which defines the extent of the tax liability or the scope of the taxing power of the entity holding tax jurisdiction in relation to a specific fiscal subject or object.

Fiscal liability can be either unlimited or limited. In case of unlimited fiscal liability, the holder of fiscal jurisdiction can assess and consequently tax all income wherever accrued on the taxpayer's part. This system is generally known as "worldwide taxation" and corresponds with the employment of personal fiscal attachments based on

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[133] Martha, R. S. J., *Extraterritorial taxation in international law*, cited above, 23.

[134] It must be noted that there are also fields where international law (or, better said, international conventions) allows state to exercise certain functional powers in connection with particular rights and privileges conferred on states by specific conventions, such as the 1982 Montego Bay Convention on the Law of the Seas, which has introduced a phenomenon which has been defined as an original fiscal jurisdiction of a territorial nature attributed to an international organisation. On the point of "functional jurisdiction" to tax, see, amongst others, Martha, R. S. J., *Extraterritorial taxation in international law*, cited above, 25 and the authors cited therein.

[135] The United States' tax system, for example, is based on the taxpayer's citizenship. However, the U.S. example constitutes an exception in the international tax arena, being that the most commonly used tax system is based on the combination of objective and subjective criteria, i.e. on the taxpayer's residence and the localisation of the source of the income.

either nationality or residence. In case of limited fiscal liability, the taxing state has the right to tax only the income derived from sources located within its territory; hence the definition of this type of system, which is generally named "territorial taxation", even though, as we are going to further develop in the following paragraphs, there is a certain degree of doubt on the correct use of such term. However it may be, limited fiscal liability corresponds with the employment of either personal fiscal attachments (short of residence) or economic fiscal attachments[136].

Needless to say that the actual descriptive value of these definitions is considerably limited, if compared with the reality of state practices in defining their tax bases. In the majority of cases, in fact, income taxes are levied by resorting to both kinds of criteria. Roughly speaking, the same state usually taxes residents on their income wherever it originates, while non-residents are taxed only if and when - and inasmuch as - their income (or part of their income) originates from sources located within the territory of the state levying taxes[137].

Furthermore, one should not underestimate the relevance, with regards to the definition of "territoriality" and its implications for the definition of the scope of the states' taxing powers, of the progressive evolution of modern systems of taxation, which have gradually gone from adhering to a "real" (or "objective") model of taxation to adopting a "personal" (or "subjective") model[138]. In many countries, in fact, worldwide taxation has been adopted as the main criterion for taxing residents when "personal" income taxation was introduced[139].

This change of perspective has also caused a shift in the point of view from which the problem of territoriality had been traditionally analysed. The "classical" theories based on the idea of taxing powers as a manifestation of the territorial sovereignty of the state over persons and things that are located therein have given way to a new perspective where the state's taxing power became not only linked to the things existing

[136] Thus, as a rule, the type of fiscal attachment employed throws light not only on the subjective side of the fiscal relationship, but also on the extent of the fiscal liability; see Martha, R. S. J., *Extraterritorial taxation in international law*, cited above, 24.
[137] This is true, though quite simplistic, as far as direct taxation is concerned, while with regards to indirect taxes, the attention is generally focused on the source of the income.
[138] Bizioli, G., *La capacità contributiva nella dimensione internazionale*, cited above, 252.
[139] Gaffuri, A.M., *La tassazione dei redditi d'impresa prodotti all'estero. Principi generali*, cited above, 296. In Italy, for example, personal direct taxation was introduced for the first time with the complementary progressiva income tax instituted in 1925. The provisions governing such tax established that the tax base should include income produced abroad and enjoed in Italian territory by persons residing therein and income produced abroad by subjects that were domiciled or resident in Italy whenever such income was not taxed in the source state by virtue of international conventions. In 1954 the tax on corporations was introduced: Italian corporations were taxed on their income wherever produced, while foreign corporations were liable to tax only on the income produced in Italy through a permanent establishment. The full adoption of "worldwide taxation" was completed through the 1970s reform, with the introduction of income tax for physical persons and collective entities.

on that state's territory, but also to the subjects who are somehow connected not much to the territory of the state, but to the state itself.

The consequence has been a deep modification of the political and economic meaning of the link connecting the state with the object of its taxes. Said link is, thus, no longer considered as being reduced only to the territory of the state, but has evolved into a "personal" or "subjective" connection between the state and the taxpayer. From this perspective, the citizen or national of the state becomes the obvious "prototype" of the taxpayer contributing to the public coffins of that state, while the problem remains as to if, when, how and how much a state should levy its taxes on aliens.

Notwithstanding the fact that the majority of the states levy their taxes on the worldwide income accrued on their nationals or residents or citizens wherever it originates[140], there are still many states[141] whose tax systems follow a strictly territorial model. On the other hand, on the international scenario, tax models based on the worldwide taxation principle vary considerably from one country to another. France, for example, taxes its residents on their worldwide income if they are physical persons and only on the income originating within French territory in case they are corporations[142]. Furthermore, some other countries exempt from taxation only certain categories of income originated abroad[143].

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[140] Notwithstanding the legitimate questions concerning nationality as a proper basis on which to ground a fiscal attachment with a tax subject, from the perspective of international law, a state could be fully entitled to tax its nationals wherever they may be, irrespective of the source of the income and irrespective of where their nationals are located. The question in this case is how to determine who can be considered as being a "national" of a certain state. Any further analysis of the problem goes beyond the scope and purpose of this research. Suffice it to say, on the point, that as far as nationality of natural persons is concerned international law essentially leaves it to national law to determine the relevant criteria to be employed, while this is not the case with regards to nationality of juridical persons. Concerning the latter, states generally hold that their nationality is that of the state of incorporation (on the point, see, for example, International Court of Justice, *Barcelona Traction*, 1970, *ICJ Rep*). However, practice shows that very few states resort to an entitlement to tax based on nationality. The most common fiscal attachment employed by states is the one based on residence, which essentially leads to the same results as a system taxing on the basis of nationality, i.e. taxation on a worldwide basis. Non-resident aliens may, thus, be taxed only on the income derived from sources located within the taxing state and on property located within the taxing state. It must be noted that some civil law countries, such as Italy and France, do not have a specific and autonomous definition of "residence" for tax purposes, essentially referring to the definition which applies for the purposes of private law, with some necessary adaptations. On the other hand, some other states (e.g. Germany and Spain) have introduced an autonomous definition of "fiscal residence", while other countries resort to entirely different and more complicated concepts (for example, the United Kingdom makes a distinction, a far as tax law is concerned, between domiciled and non-domiciled residents). For a more detailed analysis on the point, see Pistone, P., *The impact of EU law on tax treaties. Issues and solutions*, Amsterdam, 2002, 179. The question becomes even more complicated with regards to legal persons, which are essentially "juridical creations" that are not characterised by any effective and "physical" relation with the territory. Some states define the residence of a legal person referring to its place of incorporation, while, according to other states, attention should be paid either to the place where the legal person's administrative bodies are located or to the place where the board meetings for the day-to-day administration of the entity are held (so-called "place of central administration") or, again, to the place where the highest level of the decision-making process is held (the so-called "place of effective management").

[141] Such as Hong Kong, Kenya, Uruguay and, more generally, many Latin-American countries.

[142] A more detailed analysis of the French tax system will be provided in Chapter III.

[143] Switzerland, for example, does not levy any tax on business income produced abroad through a permanent establishment and also on any income stemming from real property located in foreign territory. Australia

In light of the above, it is possible to observe that the connecting factors used by states to define the scope of their taxing powers show an increasing tendency towards a progressive detachment from the territory of the state *per se*: the connection is not (or not only) with the territory anymore, but with the state itself. From this perspective, some authors have talked about a progressive "dematerialisation" of the principle (or criterion) of territoriality[144], in favour of linking criteria based on more personal elements, such as nationality, citizenship or residence, the latter to be interpreted not as a "physical" or "material" link between the taxpayer and the territory of the state, but rather as a "subjective" connection linking the taxpayer to a certain community.

Starting from an empirical analysis of the reality of international taxation, it can be observed that capital-exporting countries generally shape their fiscal systems in conformity with the "worldwide taxation" model, since the production of income by their residents on the international level largely contributes to those states' public coffins, while capital-importing countries are more incline to follow a strictly territorial tax model, given the reduced level of activity abroad on the part of their residents and the higher level of complexity required by a worldwide tax model in terms of administrative burdens[145].

In more general terms, it seems safe to say that no country that levies an income tax forgoes taxing domestic-sourced income, irrespective of who has derived it[146]. Therefore, it can be stated that, according to consolidated and uniform state practice, domestic-sourced income, as far as it is taxable, should be taxed whether derived by foreigners or by nationals. In contrast, taxation of income having its source in a foreign territory differs significantly from state to state. Most countries tax resident individuals and corporations with respect to their worldwide income and some even tax the worldwide income of citizens as well[147].

However, this general empirical rule is subject to a considerable number of exceptions.

First of all, as it has been mentioned above, some countries tax their residents on their worldwide income and non-residents only on the income having its source within their territory; other states levy income tax on a strictly territorial basis, taxing domestic-

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exempts foreign income whenever such income is already subject to tax in the state where it originates. The same applies to the Netherlands' tax system, even though only with regards to business income produced abroad through permanent establishments, dividends distributed to holding companies and some other categorie of foreign income.

[144] Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 313.

[145] Ogley, A., *The principles of international tax*, London, 1992, 23.

[146] Ault, H.J., Arnold, B.J. (eds.), *Comparative income taxation - A structural analysis*, 2010, London, 429.

[147] Vogel, K., *Worldwide vs source taxation of income. A review and re-evaluation of arguments*, in Intertax, 1988, 217.

source income and not taxing foreign income at all, while other states tax only domestic-source income of corporations and tax individuals on their worldwide income if residents or citizens or nationals. Secondly, some countries exempt only certain classes of foreign income from domestic taxation[148] and many countries exempt foreign income under double taxation conventions. The result of the interplay between the above-mentioned models in the international context is a kind of "dual situation", where connecting factors of a territorial nature are considered as only some of the multiple possible connections between a certain situation and the state or, coming to direct taxation, between a certain income and the state's taxing powers.

4.1. Allocation of taxing powers amongst states: equity and neutrality.

The debate on which of the two models (either worldwide taxation or territorial taxation) should be preferred has focused on two essential profiles: tax neutrality and equity.

Equity is a subjective criterion based on social and political - and not strictly scientific - assumptions. Equity considerations should, first of all, distinguished between those referring to the position of the single taxpayer ("individual equity") and those which refer to the positions of the state of citizenship or residence and the state of source (so-called "inter-nations equity")[149].

As far as equity with regards to the position of single taxpayers is concerned, authors have traditionally distinguished the concept of "equity" into two aspects: "horizontal equity" - requiring taxpayers in the same economic situation to be treated equally in the sense that the same taxes should be levied on the same amounts of income - and "vertical equity", meaning that taxpayers with higher income should be subject to higher levels of taxation[150]. In other words, questions concerning "individual equity" essentially amount to questions of equality. In general terms, individual equity is considered attained whenever taxation reflects the taxpayer's ability to pay, which, according to some authors' opinion, coincides with the taxpayer's income[151].

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[148] For example, Switzerland traditionally does not tax foreign business income derived through a permanent establishment located abroad.

[149] Musgrave, P.B., *Taxation of foreign investment income: an economic analysis*, Baltimore, 1963, as cited in Vogel, K., *Worldwide vs source taxation of income. A review and re-evaluation of arguments*, cited above, Part III, 394.

[150] Part of the legal doctrine has strongly adversed the distinction between "horizontal" and "vertical" equity. See, for example, Kaufman, N.H., *Fairness and the taxation of international income*, in Georgetown Journal of International Law, 1997, 145.

[151] Marino, G., *L'unificazione del diritto tributario: tassazione mondiale verso tassazione territoriale*, in VV.AA., *Studi in onore di Victor Uckmar*, Padua, 1997, 861.

As far as inter-nations equity is concerned, on the other hand, the concept relates to the circumstance that each state in the international tax arena should receive its fair share of tax revenue in relation to transactions connected to its territory. The purpose is, therefore, the equitable division of the international tax revenue between the countries that are involved to some extent in the generation of international income. Ideally, such a goal should be achieved by way of bilateral double taxation conventions or bilateral agreements between states as equal parties reciprocally recognising their mutual taxing rights[152]. From a theoretical perspective, inter-nations equity considerations generally tend to favour taxation by the source state.

According to part of the doctrine, "personal tax systems", i.e. tax systems based on the worldwide taxation principle, are more equitable than "objective tax systems", since they are supposed to take into account the actual amount of the taxpayer's wealth (its ability to pay), taking into consideration all income accrued on the same taxpayer, irrespective of the location of its sources. Economic studies, in fact, have, in general terms, shown a tendency to justify taxation at source on the so-called "benefit principle", while, from this perspective, the worldwide taxation model based on residence would be inspired to the "ability-to-pay principle"[153].

It has also been argued that a tax system based on a worldwide taxation model leads to more "equitable" results than a system based on a purely territorial model, since it would prevent any discrimination in favour of those taxpayers who produce their income, at least in part, in foreign territories, with a specific view to ensuring the application of a progressive tax rate[154].

On the other hand, the question of tax neutrality is connected to the problem of the efficient allocation of assets on the international arena and has amongst its main purposes the attainment of a higher level of efficiency in the tax system on a global level[155]. In general terms, the concept of "neutrality" is based on the assumption that productivity rises to its highest levels when productive factors are allocated by market forces without any public intervention. Tax provisions are, therefore, neutral when they

[152] Rohatgi, R., *Basic international taxation. Principles*, cited above, 23. The author highlights that reciprocity is considered as one of the key-principles in the context of international law and of international taxation.
[153] Fleming jr., J., Clifton, J., Peroni, R.J., Shay, S.E., *Fairness in international taxation: the ability-to-pay case for taxing worldwide income*, in Florida Tax Review, 2001, 301. *Contra*, Rohatgi, R., *Basic international taxation. Principles*, cited above, 22, according to whom both source taxation and worldwide taxation are based on the benefit theory.
[154] Croxatto, G., *L'imposizione delle imprese con attività internazionale*, cited above, *passim*.
[155] Garbarino, C., *La tassazione del reddito transnazionale*, cited above, 76. Some authors have proposed a distinction between the concept of "neutrality" and the concept of "efficiency" as far as allocation of taxing powers of the state in the international context is concerned, advocating that efficiency, in the sense of an efficient allocation of production factors, should be sought by states rather than neutrality. Of this opinion, Peters, C., *International tax neutrality and non-discrimination: plea for a more explicit dialogue between the state and the market*, in Lang, M. (ed.), *Tax treaties: building bridges between law and economics*, Amsterdam, 2010, 614.

do not influence - or influence to a very limited extent - the distribution of productive factors realised by market forces[156]. Briefly put, the basic idea behind the concept and theory of fiscal neutrality is that taxes should be imposed in such a way that economic processes continue to operate as if no taxes were levied at all, or, more realistically, that they are distorted as little as possible[157-158].

The underlying assumption to all of the debate at issue is that it is understood that tax laws will never be completely neutral, but as far as efficiency is desirable, a high degree of neutrality should be sought[159].

All studies on tax neutrality have essentially distinguished between two different aspects: capital export neutrality and capital import neutrality[160-161]. In short, export neutrality means that the investor should pay the same overall amount of taxes, on a global level, irrespective of the fact that he were to receive a certain income from a foreign investment or from an investment made in his country. On the opposite side, import neutrality means that capitals coming from different countries should compete in equal terms in the state where they are employed[162-163].

In general terms, countries fully endorsing the perspective of capital import neutrality - according to which the same tax burden should be levied in the state of residence on the income produced abroad by its residents and in the state of source on

[156] Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 328.

[157] Vogel, K., *Worldwide vs source taxation of income. A review and re-evaluation of arguments*, cited above, Part II, 313.

[158] Another definition of "neutrality" has been provided by Ture, according to which inter-nation neutrality means that neither country will attempt to use its fiscal powers to change relative prices in the other country, any more than it would do in absence of taxes. Consequently, Ture rejects worldwide taxation and argues for the implementation of fiscal systems based on taxation at source. See Ture, N.B., *Taxing foreign source income*, in American Enterprise Institute for Public Policy Research, *U.S. taxation of American business abroad*, Washington, 1975, as cited in Vogel, K., *Worldwide vs source taxation of income. A review and re-evaluation of arguments*, cited above, Part II, 313.

[159] Especially in the European Union context, with regards to which some authors have referred to a "market neutrality principle". See Vanistendael, F., *In defence of the European Court of Justice*, in Bulletin for International Taxation, 2008, 62, 98.

[160] Professor Richard Musgrave seems to have been the first to distinguish, with regard to the problem at hand, the aspects of capital export and capital import neutrality. According to his definition, "*export neutrality means that the investor should pay the same total (domestic plus foreign) tax, whether he receives a given investment income from foreign or from domestic sources […] Import neutrality means that capital funds originating in various countries should compete at equal terms in the capital market of any country*". Consequently, export neutrality implies a system of worldwide taxation combined with the granting of foreign tax credits, while import neutrality implies a system of territorial source-based taxation combined with the exemption of foreign-source income. See Musgrave, R., *Criteria for foreign tax credit*, in Baker, R. (ed.), *Taxation and operation abroad - Symposium*, Baltimore, 1960, 84, ad cited in Vogel, K., *Worldwide vs source taxation of income. A review and re-evaluation of arguments*, cited above, Part II, 311.

[161] In recent times the debate on capital import vs. capital export neutrality was enriched by the reference to the concept of "capital ownerhsip neutrality". Starting from the assumption that part of foreign investment is represented by the acquisition of existing assets by new owners, capital ownership neutrality would require domestic tax provisions on cross-border transactions not to distort the ownership patterns of assets. See Schön, W., *International tax coordination for a second-best world*, in World Tax Journal, 2009, 10, 71.

[162] Musgrave, R., *Criteria for foreign tax credit*, cited above, 87.

[163] Even though the distinction between capital import and capital export neutrality is traditionally embedded in the scholarly dispute concerning efficiency of international taxation, some authors have, nonetheless, highlighted that this distinction should not be relevant, since "neutrality" is a unitary concept which defines as neutral all taxes which do not interfere with economic processes. On the point see Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 331, and the authors cited therein.

the income produced by its residents exclusively within its borders - levy their taxes on a source basis only, often exempting foreign active income but taxing residents on their foreign-source passive income. Whereas, on the other hand, countries adhering to the capital export perspective tend to shape their tax systems according to the worldwide taxation model.

Even though there is unanimous consensus on the fact that the principle of capital import neutrality (also known as "external neutrality") ensures a higher level of growth and competitiveness of the enterprises operating in foreign territories, there is almost equal consensus on the circumstance that such neutrality cannot be attained unless tax rates are the same in all countries, given the considerable number and heterogeneity of the subjects with which enterprises operating abroad come into contact. The traditional mainstream opinion, therefore, has been - at least until recently - that a system based on export neutrality (or "internal neutrality") should be preferred, with the consequent implementation of systems based on the worldwide taxation principle.

Some authors have argued that international efficiency might be attained only by adhering to a model based on export neutrality, which might be reached exclusively by action performed by the legislature of traditional "residence countries" (that is to say capital exporting countries).

More specifically, it has been theorised that capital export neutrality, being able to ensure that each national supply of capital available at that tax level is allocated internationally in its most efficient manner, should be preferred to a model aimed at attaining capital import neutrality. The latter, in fact, would arguably result in a system under which all investors who invest in one particular country are subject to the same treatment (i.e. that of the country of the source of investment income), thus allowing all foreign investors in that country equal opportunities for expansion, but, on the other hand, amounting to a system that would be highly non-neutral to international capital flows, unless all tax rates were equal[164].

In light of these reasons, during the 1960s and 1970s, scholars advocated the need of a system aiming at export neutrality, i.e. at a tax model based on the "worldwide principle" (or better "worldwide criterion"), whereas, during the 1980s, worldwide taxation and the capital export neutrality perspective was harshly criticised by those who argued that such a model was able to impair international trade and, therefore, to damage both the state of residence and the source state.

[164] Musgrave, P.B., *Taxation of foreign investment income: an economic analysis*, cited above.

Many international bodies, such as the International Chamber of Commerce and the International Fiscal Association, have embraced the idea of capital import neutrality, thus favouring a tax model based on a strictly territorial criterion, opting for a model based on income taxation at source and a corresponding exemption of foreign-source income on the part of the state of residence of the taxpayer[165]. This has traditionally been the approach held also by the United Nations, which have come up with a Model Double Taxation Convention that provides for a higher level of taxation at source and which is alternative to the OECD Model (that is traditionally more oriented towards a capital export neutrality model and the implementation of a tax system based on worldwide taxation of residents).

Part of the Italian doctrine has voiced similar opinions, highlighting that a model pursuing capital import neutrality (and taxation at source of foreign income) would have to be preferred to a worldwide tax model, because it would grant a higher level of international competitiveness to enterprises and businesses operating abroad, which would, therefore, be subject to the same level of local taxes levied on other business operating in the same country (and in the same market), thus preventing distortions caused by taxation[166]. It was also stressed that a model based on taxation at source would be simpler than the one based on worldwide taxation, also because states would not need to implement complex procedures and standards for granting tax credits for taxes paid abroad. Contemporary German scholars have advocated similar views, stating that the "ideal solution" in order to prevent double taxation would be the implementation by all countries of a purely territorial tax system, based on objective criteria[167].

On the other hand, different authors have, however, highlighted that such a system would imply a "transfer of (tax) sovereignty" on the part of the state of residence of the taxpayer in favour of the source state[168], with states of residence "renouncing" the possibility to "supervise" investments made abroad and, thus, being impaired in effectively implementing a tax system based on the ability to pay of the taxpayer and on progressive tax rates.

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[165] On the point see International Chamber of Commerce, *Avoidance of double taxation, exemption and tax credit method - Resolution of the International Chamber of Commerce Council and Report of Commission on Taxation*, Paris, February, 1955 (quoted by Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 329), and International Fiscal Association, *Fiscal obstacles to the international flow of capital between a parent and its subsidiary*, in *LXIX Cahiers de droit fiscal international*, Deventer, 1984 (also quoted by Sacchetto, C., *Territorialità (diritto tributario)*, cited above, 329).

[166] Maisto, G., *Imposizione dei redditi prodotti all'estero e competitività internazionale*, in Dir. prat. trib., 1981, 1, 1135.

[167] Vogel, K., *Worldwide vs source taxation of income. A review and re-evaluation of arguments*, cited above, *passim*.

[168] Garbarino, C., *Di alcuni principi che informano le norme tributarie interne in materia di tassazione del reddito prodotto su base internazionale*, in Riv. dir. fin., 1989, 1, 44.

Discussions on the potential effects of worldwide and territorial taxation generally focus on the impact on government revenue in the home country and on the competitiveness of the home country on the international market, i.e. the consequences on the attractiveness of that country in the eyes of foreign investors. These discussions also take into account the possible "spill-over effects", which essentially refer to the ways the impact of one country's policies or changes in policy can have on other countries.

More recently, part of the doctrine has highlighted that an analysis of allocation of taxing powers amongst states which focuses only on the traditional concepts of capital export neutrality and capital import neutrality is by nature incomplete, since it underestimates or even disregards the essential role of one of the two fundamental economic factors, i.e. capital and labour, focusing only on the first one. According to these authors, therefore, it would be necessary to reshape the essential traits of the debate in order to take into account labour as well, thus leading to the adoption of two different models, i.e. "capital and labour export neutrality" (CLEN) and "capital and labour import neutrality" (CLIN)[169].

A model based on capital and labour export neutrality would be characterised by the fact that the overall tax burden imposed on the income (taking into account both domestic taxation and taxation at source) should be the same irrespective of which productive factor (capital or labour) has produced the income and irrespective of the state (residence state or source state) it comes from. This model would, according to its creator[170], call for the implementation of a tax model based on taxation in the state of residence with a full credit being granted to the taxpayer for taxes paid abroad.

On the other hand, a model based on capital and labour import neutrality would entail that capital and labour employed in various states should be granted the same conditions in the market of the labour and in the market of the capital, without being it possible for the place of residence of the worker or of the investor to be a reason for a difference in treatment. This model would require the implementation of a "purely territorial" taxation, with each state having the right to tax only the income produced within their territories and with the exemption of foreign income from taxation[171].

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[169] Kemmeren, E.C.C.M., *Source of income in globalising economies: overview of the issues and plea for an origin-based approach*, in Bulletin of International Taxation, 2006, 3, 430.

[170] Kemmeren, E.C.C.M., *Source of income in globalising economies: overview of the issues and plea for an origin-based approach*, cited above, 440.

[171] Kemmeren, E.C.C.M., *Source of income in globalising economies: overview of the issues and plea for an origin-based approach*, cited above, 440. The author opts for a model based on capital and labour import neutrality, stating that taxation based on the worldwide principle creates a non-neutral and inefficient system, while a system based on territoriality would allow enterprises to conduct business on the same level and at the same conditions as their foreign competitors. More specifically, the author states that "*a tax system based on the territoriality principle would contribute to an efficient allocation of the production factors worldwide. CLEN ha salso been advocated because it prevents*

However, irrespective of which "model of dualism" one adheres to (either CIN vs. CEN or CLIN vs. CLEN) and even though, according to economic doctrines, the best scenario would be "tax equalisation", i.e. a context where states reach an equilibrium between individual equity, inter-nation equity and neutrality, through the adoption by all states by a coordinated and integrated structure of their respective tax systems, such a purpose seems still quite unattainable, especially because of the lack of a coordination between fiscal systems, which, according to some, could be reached only in presence of just one global tax legal order to which single states should respond.

Therefore, even though, according to economic doctrines, the best scenario would be "tax equalisation", i.e. a context where states reach an equilibrium between individual equity, inter-nation equity and neutrality, through the adoption by all states by a coordinated and integrated structure of their respective tax systems, such a purpose seems still quite unattainable, especially because of the lack of a coordination between fiscal systems, which, according to some, could be reached only in presence of just one global tax legal order to which single states should respond.

4.2. The enactment of case-by-case solutions for the allocation of taxing powers by way of bilateral agreements: the "tax design" of the OECD Model Convention.

A study on tax territoriality and allocation of taxing powers amongst states cannot be considered exhaustive and complete if it does not take into account the effects of bilateral tax conventions as the main instrument, *rebus sic stantibus*, for the allocation of taxing powers amongst states, which can significantly alter the implementation of the relevant connecting criteria between the income and the state levying the taxes.

We have already highlighted in the previous pages of this work that simultaneously applying a system of "worldwide taxation" to residents and a system of strictly territorial taxation (taxation at source) to non-residents leads to the inevitable consequence of giving rise to international juridical double taxation[172]. And that is because, naturally, a taxpayer who produces a certain item of income in foreign territory

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the shift of investment capital from high-tax to low-tax jurisdictions. Consequently, enterprises in low-tax states might increase their market shae through lower prices to the detriment of enterprises resident in high tax states, even though the latter are more efficient".

[172] The causes of double taxation have been identified in the following circumstances: 1) the overlapping of taxes imposed by two states considering the income deriving from the same element or event located within their respective territories; 2) the overlapping of taxes by two states with regards to the same element and based on the definition of "resident" by both countries when at least one of the two states follows a model based on worldwide taxation; 3) the overlapping of taxes by two states if one of them taxes on a territorial basis and the other one on a worldwide basis; 4) the result of different interpretations given by two states to the same concept

is going to be taxed on that income by two different states, i.e. the state where he resides (or the state of which is a citizen) and the state where the source of the income at issue is located. The solution to these problems caused by the concurring effects on the two above-mentioned linking criteria and the consequent identification of the tax regime applicable to cross-border income implies resorting to complex rules establishing the qualification of the category of income to which the relevant income belongs, the localisation of said relevant income and, thirdly, the specific tax treatment applicable. And this is precisely the purpose of bilateral tax conventions.

We have also already specified that there is almost unanimous consensus, nowadays, on the fact that the international order does not entail any principle or general rule prohibiting double taxation[173]. Nonetheless, with a view to preventing problems connected to international juridical double taxation, some have argued in favour of the adoption by states of purely territorial systems or, in other terms, of tax systems modelled on the source principle, thus *a priori* exempting foreign income from the states' tax bases. This - probably utopic - theory starts from the assumption that, if all states adopted such a model, there could be no problem with regards to double taxation, if we exclude the cases of double residence of the taxpayer or cases of conflicting rules on the localisation of the income. These more general solutions seem quite unattainable in the current international context, at least on a global scale, whereas the possibility to conduct such an attempt could be verified in more restricted geographical areas, such as the European Union, as this work will attempt to highlight.

Aside from general solutions of this sort, states still try to solve problems connected to international double taxation by resorting to a case-by-case approach through bilateral tax treaties.

As known, the main purpose of bilateral tax treaties is to eliminate, or at least to lessen, the negative effects of the exercise of two states' concurrent taxing powers over the same cross-border income. Their *ratio* is, therefore, opposite to the one inspiring state legislation on a merely domestic level: if, as seen above, national tax law aims at extending state's taxing powers over all facts on which it is actually possible to enforce tax provisions, on the other hand tax treaties deal with the need to somehow limit the state's taxing powers in order to prevent double taxation[174].

[173] Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 69; Chrétien, M., *A la recherche du droit international fiscal commun*, Sirey, 1955, *passim*; Adonnino, P., *Doppia imposizione*, cited above, *passim*.
[174] Baker, P., *Double taxation agreements and international law*, London, 1994; Rohatgi, R., *Basic international taxation. Principles*, cited above, 6.

That is why it has been traditionally stated that double taxation conventions have limiting effects only, meaning that conventional tax provisions cannot give rise to or either expand the state's taxing powers, but can exclusively restrict such power (or, more correctly, the exercise of such power) or leave it unchanged. Treaties enshrine essentially distributive rules: once the tax treaty has established that a certain item of cross-border income can only be taxed by one state, that state will levy tax on that income according to its domestic fiscal provisions. Some authors have even stated - in a quite unconvincing way - that this "rule", according to which tax treaties cannot make the fiscal situation of a taxpayer more burdensome and taxpayers should always be able to obtain that only national tax provisions are applied in case a tax treaty were to make his/her/its tax burden heavier, would amount to a customary international rule would exist[175].

On the point, it should, however, be noted that the fact that double taxation conventions do not generate new fiscal obligations and do not render the situation of a single taxpayer more burdensome than how it would be according to national law only seems to be the result of how tax treaties are shaped and of the content and purpose of the single provisions enshrined therein, rather than the result of a theoretical - but considerably hard to demonstrate in practice - customary rule. One should not forget, in fact, that states resort to bilateral tax treaties in order to provide mutual limitations to their taxing powers in order to prevent the occurrence of double taxation once they have established that double taxation is prejudicial to international trade, and certainly not to expand their taxing powers, thus making the problem worse.

Going back to the main topic at hand, i.e. the allocation of taxing powers amongst state and the effects of such allocation, double taxation conventions entered into by the majority of Western countries (aside from the United States, which have their own tax treaty model) generally follow the Model Convention drafted by the OECD, which acknowledges both of the above-mentioned tax systems, i.e. the "territorial taxation" model and the "worldwide taxation" model, and calls for the implementation of both territorial and worldwide criteria.

Notwithstanding this fact, the OECD Model Convention's outline is essentially based on the taxation of "residents" of one of the contracting states, even though the

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[175] This is, for example, the opinion voiced by Melis, G., *Vincoli internazionali e norma tributaria interna*, cited above, *passim*, and by Miraulo, A., *Doppia imposizione internazionale*, Padua, 1990, 58. The debate on the point, however, has been given a limited degree of attention by North-American doctrine and, in general terms, also by European tax scholars, exception made with regards to French authors, who have dealt with the topic with much more attention.

definition of "residence" is left to domestic provisions[176], thus essentially embracing the worldwide taxation principle.

It is therefore correct to state that, in general terms, the OECD Model Convention endorses an allocation of powers according to which the source state is endowed with limited taxing powers, while the state of residence has unlimited taxing powers. Correspondingly, according to the Model, the duty to eliminate or reduce conventional cases of double taxation lies entirely on the state of residence.

As far the source state's taxing powers are concerned, the Model provides for different ways and "intensities" of such powers depending on the category of income at issue. In general terms, the source state might either have a limited or unlimited taxing power on a certain kind of income or even have no taxing power at all on another kind of income. Then, for the purposes of preventing the occurrence of any international double taxation, in cases such income might be taxed (with or without limitations) by the source state, the state of residence will generally be called to either granting the taxpayer a tax credit or, in alternative, exempting from taxation all items of income that have already been subject to tax by the source state.

Alongside provisions granting the source state exclusive taxing powers with regards to cross-border income (as for income from government employment pursuant to Article 19, with regards to which the residence state is deprived of any taxing right), the OECD Model Conventions, at certain conditions, provides for an unlimited taxing power for the source state, for example, with regards to the taxation of business income received by a subject who is resident of a contracting state through a permanent establishment located in the other contracting state.

However, contrarily to domestic legislation, Article 7 of the OECD Model Convention opts for a "limited" attractive force of the permanent establishment, which means that, once it has been established that the income to be taxed is business income and that there is a permanent establishment in the state where such business income has its source, the source state can levy tax on that income only insofar as such income can be attributed to the permanent establishment. The OECD Commentary to the Model Convention further specifies that the source state's right to tax does not extend to income

[176] Article 4 of the OECD Model Conventions provides that "*for the purposes of this Convention, the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof*". In case the difference between the parameters adopted by the contracting states were to lead to a situation of "double residence", the second and the third paragraphs of Article 4 of the OECD Model Convention provide tie-breaker criteria in order to solve these sorts of conflicts. For a more detailed analysis of the problems connected to the concept of residence in the context of international tax law, see Maisto, G. (ed.), *Residence of companies under tax treaties and EC law*, Amsterdam, 2009, *passim*; Avery Jones, J.F., *Place of effective management as a residence tie-breaker*, in Bulletin of International Fiscal Documentation, 2005, 20.

that the foreign business receives on its territory without any effective intervention by its permanent establishment located therein, but is limited only to any income effectively connected to the permanent establishment's activity.

The OECD Model suggests a similar criterion based on an effective connection between the state and the income on which tax is levied to the taxation of other categories of income as well, such as dividends, interests, royalties, capital gains and "other income". As far as such kinds of income are concerned, in fact, conventional benefits are not granted when the beneficial owner who is resident of one of the contracting states exercises a business activity in the other contracting state through a permanent establishment located therein if such income is effectively connected to such permanent establishment[177].

An analogous restriction of the states' taxing power is provided, in the OECD Model Convention, with regards to income from employment. According to Article 15 of the Model Convention, in fact, salaries and other similar income received by a non-resident subject can be taxed in the state where the employment is exercised if certain conditions are met[178]. In that case, the "source state" can levy tax on the salaries without limitations, whereas, if such conditions are not met, that state does not have any taxing power in relation to such income.

According to the OECD Model Convention, with regards to certain other categories of transnational income, tax territoriality is conventionally limited and, consequently, such kinds of income are subject to limited powers of taxation on the part of the source state.

This is the case, for example, as far as dividends are concerned. With regards to outbound dividends, in fact, Article 10 of the OECD Model Convention does not entrust any right of full taxation either to the state of residence of the taxpayer or to the state of

[177] Tax treaties signed by Italy generally adopt such criterion based on the "effective connection" concept, notwithstanding the fact that Italy has reserved the right to tax single items of such income as business income, according to its domestic tax law, whenever the beneficial owner has a permanent establishment in Italy, even if there is no effective connection between the income and the permanent establishment. Some problems may arise with regards to the allocation of the income between the state where the enterprise has its seat and the state where the permanent establishment is located. On the point, Article 7 of the OECD Model Convention provides for the application, as main criterion, of the rule according to which the permanent establishment can be attributed all income that it is possible to deem would have been received if the permanent establishment had been a distinct and separate enterprise performing identical or similar activities in identical or similar conditions and in a fully independent way from the enterprise of which it constitutes an establishment.

[178] Pursuant to Article 15.2, "*notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if: a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and c) the remuneration is not borne by a permanent establishment which the employer has in the other State*".

source of the dividends[179]. More specifically, Article 10 provides, on one hand, that dividends can be taxed by the state of residence of who receives them and, on the other hand, that, in any case, a right to tax is reserved to the source state (i.e. the state where the company distributing the dividends has its seat or, in any case, its fiscal residence). Such a right, however, is considerably limited by the fact that the source state is deemed to have already taxed the underlying income of the company distributing the dividends at company level[180].

Such limitation to the source state's taxing power is conditioned upon the fact that the taxpayer who receives the dividends is the actual beneficial owner of such income, i.e. the subject who economically and legally owns the shares conferring the right to receive the income. In case that subject is not the beneficial owner of the income and a third subject (intermediary) is interposed between the company distributing the dividends and the beneficial owner of such dividends the limitation of the taxation at source cannot be granted, unless the actual beneficial owner of the dividends is also a resident of the other contracting state. The OECD Model Convention proposes a similar "compromise" with regards to interests as well[181].

In other cases, on the contrary, the OECD Model Convention establishes that, as far as certain categories of income are concerned, a derogation to tax territoriality should be implemented and that, therefore, such income should be taxed exclusively by the state of residence of its beneficial owner. This is the tax treatment of cross-border royalties pursuant to Article 12 of the OECD Model Convention, which prevents the source state from levying taxes on outbound royalties[182].

Furthermore, tax territoriality does not apply, according to Article 21 of the Model Convention, to all "other income", that is to say to all categories of income not

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[179] This is presumably partly due to the fact that some states (e.g., the Netherlands) do not provide for any taxation at source of outbound dividends.

[180] Pursuant to Article 10 of the OECD Model Convention, "*dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State. However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that States, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends; b) 15 per cent of the gross amount of the dividends in all other cases*".

[181] With the only difference that, according to Article 11 of such Model Convention, in order for such a limitation of the source state's taxing power to be granted another condition must be met, besides from the one mentioned above with regards to beneficial ownership: the amount of the interests must not exceed the amount determined with reference to the "normal value" criterion, in light of particular relationships between the subject paying the interests and their beneficial owner. The possible difference between the amount of interests paid and the "normal value" of the income may be taxed by the source state according to its domestic law.

[182] Pursuant to Article 12 of the OECD Model Convention, "*royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State […] The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply*".

provided for by different provisions of the tax treaty. Such an income may be taxed only by the state of residence of whoever receives them, irrespective of where they come from.

After having defined the allocation of taxing powers between contracting states in the terms described above, the Model, then, provides, pursuant to Articles 23A and 23B, two methods for the elimination of double taxation: the state of residence of the taxpayer is allowed to tax the foreign income, but it must either recognise a credit for the tax paid by that taxpayer in the source state or, alternatively, grant an exemption from tax.

A more detailed analysis of the differences between the exemption method and the credit method and of their economic and legal consequences on taxpayers and states is beyond the scope of the present research. Suffice it to say, here, that, as it has been correctly observed, the exemption method is generally preferred by states adhering to a strictly territorial tax model. The state of residence of the taxpayer refrains from exercising its taxing power over a certain item of income whose source is located abroad in favour of the state where such income has been produced. Practically speaking, the state of residence of the taxpayer receiving the income excludes such income from that taxpayer's tax base, leaving the exclusive power to levy tax on the income up to the source state[183].

The implementation of such a mechanism on the part of the state of residence does not entail any relationship with the tax burden imposed by the source state: the relevant item of income is not taxed irrespective of the fact that the source state levies tax on it or actually collects the tax possibly levied[184]. In practice, however, states often provide for some "corrective measures" by virtue of which, for example, the foreign item of income is exempted from taxation only if considered taxable according to the source state's domestic law or only if actually taxed by that state.

Needless to say that the implementation of the exemption method requires states to renounce or, at least, significantly reduce the exercise of their tax jurisdiction, which has led states, until recent years, to opt for the different (though more burdensome) credit method.

[183] The exemption method is generally distinguished into two categories, i.e. "full" exemption and exemption combined with the implementation of elements that ensure the application of a progressive tax rates. More specifically, according to the first method, the state of residence does not take into any consideration for any purposes the foreign income at hand, while, when applying the second exemption method, the state of residence reserves the right to include such foreign income in the computation of the taxpayer's tax base only for purposes of calculating the exact tax rate to apply to the taxpayer's income generated in the state of residence, in order to comply with the general principle of progressivity of taxation.

[184] For this reason, according to scholarly opinion, the exemption method is the method which is closer to reaching the objective of eliminating international double taxation.

On the other hand, the credit method is generally preferred by those states that have chosen to follow the worldwide taxation model. Foreign income is taxed both in the source state and in the state of residence of the taxpayer, but the latter relieves, at least partly, the taxpayer from the burden of taxes paid abroad through the granting of a tax credit that is then used to reduce the amount of taxes due to the state of residence.

States generally provide for certain quantitative conditions limiting the full implementation of the credit method: some states grant a tax credit only if the relevant tax has actually and definitely paid by the taxpayer to the source state; other states limit the credit to the percentage of the tax which would have been levied by the state of residence if the income at issue had been of merely "national" nature; some other states, furthermore, grant a "presumed" tax credit, thus preventing the possible effect of neutralising the deductions possibly granted by the source state. Again, tax credits may be granted on a "global" level, in relation to the amount of all taxes paid by a resident subject to foreign countries, or separately for taxes paid in single foreign countries.

If it is true, on one hand, that such a mechanism ensures a higher level of tax neutrality in international trade, it is also true, on the other hand, that, according to some observers, the tax credit system entails a sort of transfer of the possible tax advantages granted by the source state to the state of residence of the taxpayer. In fact, all fiscal advantages (e.g. deductions) the taxpayer might be granted in the state of source of his income would be automatically "absorbed" by a corresponding higher tax burden imposed by his state of residence, since the credit granted by the state of residence is usually equal to the tax effectively paid by the taxpayer in the source state[185]. In other words, the less the taxpayer pays to the source state, the more he will have to pay to his state of residence. This is one of the reasons justifying the criticism against the current tax credit system, especially coming from developing countries.

A third method, which is very rarely used by countries, entails the state of residence allowing the deductibility from the tax base of taxes paid abroad, thus, to a certain extent, considered as "expenses" inherently linked to the production of the income.

Going back to the main topic, there is no need to say that bilateral treaty practice by states does not always totally adhere to the rules provided for by the OECD Model. Sometimes, for example, bilateral double taxation conventions reserve the source state the right to levy tax on passive income having its source in the state's territory, normally

[185] Manganelli, A., *Territorialità dell'imposta*, cited above, 371.

establishing a maximum "cap" for the relevant tax rates. This is what often happens with regards to cross-border royalties[186].

It also goes without saying that the OECD Model Convention is nothing more than a model, with no actual binding force on any of the states that are part of the OECD, even though the OECD Commentary to the Model Convention is being used more and more as a parameter, even by the Court of Justice of the European Union, to establish the legitimacy of certain domestic tax provisions with effects on international trade. Needless to say that the OECD Model voices the positions of the great majority of industrialised capital-exporting countries, which makes it easy to understand why most of its "suggestions" tend to privilege the state of residence of the taxpayer and to limit the taxing powers of the state where the income has its source[187].

On the other hand, the Model Convention drafted by the United Nations has assumed a different perspective, being it a model for the negotiation of bilateral tax treaties between an industrialised country and a developing capital-importing country. The UN Model grants higher taxing powers to the state where the income has its source, reducing to a minimum the cases where the state of residence of the taxpayer has exclusive power to tax, thus also mirroring developing countries' common practice to levy taxes only on income whose source is located within their national territory and not to tax income produced abroad[188].

Having established all of the above, one should also note that, at the international level, there is general consensus on the fact that the current situation concerning tax-treaty law should be considered unsatisfactory[189], up to the point that a considerable number of authors have advocated the need either to rethink double taxation conventions or to abandon them entirely[190].

Besides these "extreme" positions, it is true that the "system" created by the current double taxation conventions and by the (unilateral and/or bilateral) mechanisms for the elimination of double taxation (exemption or deduction) seems precarious and somehow erratic. On one hand, states, with their national provisions, constitute the primary cause of the phenomenon of double taxation, even though justified by the need to pursue the domestic purpose of efficiency (e.g. worldwide taxation and progressivity)

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[186] The majority of tax treaties signed by Italy, for example, provide for the possibility for the source state to levy a withholding tax at source on outbound royalties, establishing, however, that the tax rate of such withholding tax cannot be higher than a certain level. Generally, such a limitation of tax rate by the state of source is conditioned upon the fact that whoever receives the outbound royalties is the actual beneficial owner of that item of income.

[187] The same perspective has been adopted by the United States Model Convention.

[188] Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above. 172.

[189] Tarigo, P., *La doppia imposizione giuridica internazionale come fattispecie disciplinata nei trattati bilaterali*, cited above, 902; Tremonti, G., Vitaletti, G., *La fiera delle tasse*, Bologna, 1991, 114.

[190] Easson, A., *Do we still need tax treaties*, in Bulletin for International Taxation, 2010, 12, 619.

and fight against international tax evasion and avoidance. On the other hand, by entering into bilateral tax treaties, states try to eliminate or reduce the effects created by their own domestic rules, pursuing, on a case-by-case basis, aims of both substantial equity (preventing double taxation) and economic policies, i.e. placing their residents (taxpayers) in a more favourable position in the international market at attracting foreign investors.

The unsatisfactory and inherently partial solutions posed by double taxation conventions, combined with the needs posed by the new economies and the new ways international trade is conducted, led states, international organisations and scholars to look for new (or improved) coordinating criteria for the exercise of the states' concurring taxing powers.

5. Recent developments of the debate on worldwide and territorial taxation.

In light of all of the above, and notwithstanding all that has been said in the age-old debate on equity and neutrality in international taxation, two considerations may certainly be considered as scientifically true: on one hand, the source state grants the conditions allowing the income to be produced and paid to the foreign taxpayer, following that the source state can legitimately exercise its right to levy taxes on that income; on the other hand, however, many have stated that it would be unthinkable for traditional "residence states", i.e. industrialised countries, to entirely give up all their taxing powers with regards to foreign income, since doing so would amount to renouncing to effectively implement principles such as taxation according to ability to pay and progressivity.

Lately a large number of international tax scholars - many of which have resorted to arguments which had been already developed by traditional authors in the first half of the XX century - have advocated the need for a "return to territoriality", that is to say the need for states to shape their tax systems according exclusively to a model based on taxation at source, which is seen as a tool to ensure both economic efficiency and international equality (or, at least, a higher level of efficiency and equality on the international arena)[191].

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[191] Vogel, K., *Worldwide or source taxation of income?*, in Rass. Trib., 1988, 1, 259; Vogel, K., *Worldwide vs source taxation of income. A review and re-evaluation of arguments*, cited above, *passim*; Harris, P.A., *Corporate/shareholder income taxation and allocating taxing rights between countries*, Amsterdam, 1996; Kemmeren, E.C.C.M., *Principle of origin in tax conventions. A rethinking of models*, in Themes, 2003, 279; Vanistendael, F., *Reinventing source taxation*, in EC Tax Review, 1997, 152; Cipollina, S., *I confini giuridici nel tempo presente. Il caso del diritto fiscale*, Milan, 2003, 29. Furthermore, theories advocating the return to a purely territorial tax system have developed especially in Latin American countries, which have traditionally emphasised territoriality in income tax legislation. Latin American

In other words, it has been stated that the implementation of only one kind of model, if consistently applied, could avoid the negative results of the interplay between the different tax systems and would entail a fair and equitable distribution of tax burden and allocation of taxing powers. According to the opinion that is being discussed, in slightly simplified terms, taxation by the country of residence is considered as potentially unjust to the taxpayer who has earned his income in other countries and also to the source country because, in stripping away part of its tax base, it also disrupts the source state's tax policy decisions. It is essentially stated that a consistent and uniform application of territorial taxation would allow granting equal tax treatment both to residents and non-residents, thus preventing possible discriminations to the detriment of both.

According to a large part of the authors representing this view, given the assumption that a taxation of investment in foreign countries may be seen as economically efficient only if the investor pays no more tax than is imposed on domestic enterprises in the same country in which the enterprise was established, this assumption may be considered consistent with a model founded on source-based taxation, if the concept of "source" is defined as the place where the enterprise established by direct investment is located[192].

A central role in this more recent view is played by the so-called "benefit theory"[193], or, better said, to one of the interpretations of the benefit theory, according to

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authors have been particularly committed to promoting the principle which they considered to be a matter of equity not only with regards to the taxpayer, but also, and even more, with regards to the states involved. For example, in a "Declaration of Principles", the First Latin American Tax Law Convention of 1956 proposed that the principle of territoriality should be the exclusive principle of taxation within and amongst Latin American states for the taxation of cross-border transactions. This position has, however, been partially revised in the following years, when all Latin American Tax Law Conventions advocated that the principle of territoriality should be the main (not exclusive) principle of taxation, thus not excluding that the source principle, based on material links between the income and the territory (such as the production of the income, its perception, the existence of certain goods in the territory, etc.), could co-exist with personal linking criteria which are typical of worldwide taxation (such as residence, nationality, domicile, etc.). Notwithstanding these assumptions, positive tax law of Latin American states (e.g., Chile, Colombia, El Salvador, Mexico, Peru) is not always compliant, in practice, with the territoriality criterion.

[192] Vogel, K., *Worldwide vs source taxation of income. A review and re-evaluation of arguments*, cited above, Part II, 315; Vogel, K., *Taxation of cross-border income, harmonisation and tax neutrality under European Community law. An institutional approach*, Deventer, 1993, 22.

[193] This theory, though recently re-discovered, dates back to Grotius and was first developed in a juridical, financial and economic meaning by Adam Smith (Smith, A., *An inquiry into the nature and causes of the wealth of nation*, London, 1776). In Italy, this doctrine has been developed by several influential and "traditional" authors, who, in the past, pointed out the "benefit criterion" as the fundamental rule for the allocation of taxing powers amongst states in order to avoid double taxation, as highlighted in Marino, G., *L'unificazione del diritto tributario: tassazione mondiale verso tassazione territoriale*, cited above, 847. Some "classical" Italian tax scholars of the XIX and XX centuries, for example, stated that social services should be financed by those taking advantage of them, thus asserting the need that, in all states, taxes levied on each taxpayer reflect the advantages drawn by said taxpayer from the services rendered by the public sector. In the first half of the XX century, however, with the renown 1923 League of Nations report *Sur la double imposition présenté au Comitié financier par MM Bruins, Einaudi, Seligman et Stamp*, a change of perspective was proposed, shifting the focus from the concept of "benefit" to the concept of "ability to pay" as the main criterion for allocating taxing powers amongst states. From this evolution followed the attention paid to concepts such as the source of the income and the residence of who receives the income.

which, as it has already been mentioned above, taxing powers would better be left to the state of source, that state being the one granting (the main part of) the services contributing to the production of the income, at least as far as active income is concerned. This theory, which some authors elevate to the level of "principle", is founded on the assumption that the state of residence has the primary right to tax passive income, whereas the state of source has the primary right to tax active business income[194].

However, staying on the point of the "benefit theory", it has also been argued that both the state of residence and the source state can be considered as legitimately entitled to a tax claim on the grounds of services provided, but that the share of services provided by the source state is typically higher than that provided by the state of residence.

Some authors advocating the need for a return to pure territoriality and taxation at source have also stated that, in case of multinational corporations, source-based taxation seems generally preferable. One of the reasons underlying this assumption is that residence of corporations is difficult to establish and relatively meaningless, since residence based on place of incorporation is formalistic and easy to manipulate by the taxpayer, which can be said with regards to residence based on the place of effective management and control as well. Moreover, multinationals are considered as not being part of a single society or country, but of many societies and countries, which assumes relevance for distributive purposes[195].

Another reason to the same point is partly based on an application of the above-mentioned "benefit theory". It has been argued, in fact, that one should also consider that business income received in the source state may not be immediately received and enjoyed in the state of residence of the taxpayer, since often, on the contrary, such foreign income is reinvested in the enterprise in the source state. In light of this consideration, foreign income staying in the foreign should not be equated to income that is under the disposition of its owner in the state of residence and, therefore, it has been argued that states should at least distinguish, for tax purposes, income over which the owner has direct disposition from income on which his disposition is more remote, implementing a sort of "limited worldwide taxation" system[196].

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[194] Avi-Yonah, R.S., *The structure of international taxation: a proposal for simplification*, in Texas Law Review, 1996, 74, 3106.

[195] Avi-Yonah, R.S., *International tax as international law. An analysis of the international tax regime*, cited above, 11.

[196] Especially if we consider that, exception made for certain peculiar cases, corporate income is taxed in all countries only at the corporate level, as long as it has not been remitted to the owner. A similar assumption is the one underlying the manner the United Kingdom taxes foreign income of non-domiciled residents, by way of which certain items of income of such residents are taxed only as far as they are remitted to the United Kingdom.

As mentioned above, from a theoretical perspective, inter-nations equity considerations tend to favour taxation by the source state, insofar as the non-resident taxpayer is effectively integrated in the economic life of the host state, being it possible to assume that such taxpayer owe a certain degree of "economic allegiance" to the state for having enjoyed the benefits it provides[197].

Another more practical argument which the authors advocating the necessity of a purely territorial tax system resort to is that the source jurisdiction has by definition the "first bite at the apple" or, in other terms, it has the first opportunity to collect the tax on payments derived from within its borders, which would make it extremely difficult to prevent source states from levying the tax.

On the other hand, it has been highlighted that the theory advocating the return to a model of "pure territoriality" is based only on justifications of a purely economic nature. The same authors have, furthermore, asserted that the theory itself does not take into account or underestimates the national reasons justifying the implementation of the worldwide principle, amongst which, for example, the need to respect the domestic principle of equality and the principle of progressivity of taxation (which are generally embedded in the majority of Western legal systems), the need to prevent international evasion and avoidance and the fact that such a system would encourage enterprises to take their business (or part of their business) abroad and to relocate their plants in foreign territories.

One of the reasons expressed by those supporting "worldwide taxation" as the preferable tax model is the need not to discriminate between taxpayers on the base of the different source of their income. In fact, in case states were to levy taxes only on income produced on their territory, the consequence might be to favour those taxpayers who produce part of their income abroad, especially with concerns to the application of a progressive tax rate. Worldwide taxation would be, in other terms, neutral with regards to both domestic and foreign investments, thus avoiding discriminations on the base of the place of source of the income[198].

Furthermore, as far as the argument based on the "benefits theory" is concerned, it has been highlighted that the state of residence of the taxpayer contributes to the production of the income as well, even if such income is produced abroad, protecting the

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On the point, see Vogel, K., *Worldwide vs source taxation of income. A review and re-evaluation of arguments*, cited above, Part III, 396.

[197] López, E.E., *An opportunistic, and yet appropriate, revision of the source threshold for the twenty-first century tax treaties*, in Intertax, 2015, 1, 7; Pinto, D., *E-commerce and source-based income taxation*, in Bulletin for International Fiscal Documentation, 2003, 19; Avi-Yonah, R., *International taxation of electronic commerce*, in Tax Law Review, 1997, 3, 507.

[198] Croxatto, G., *La imposizione delle imprese con attività internazionale*, cited above, 159.

interests of the taxpayer and granting services that allow the development of its economic activity, thus being "entitled" to levy tax as well as the source state (if not more than the source state, according to some scholars)[199].

Another problem with the theories supporting the establishment of tax systems based exclusively on taxation at source is linked with the absence of, and the difficulty in reaching, a unanimous definition of what constitutes "source", which is unanimously recognised as not being a self-defining concept. It has been stated, in fact, that the concept of "source" is "*unambiguous only in what it excludes: taxation based on source is different from taxation based on residence or on citizenship*" and that if the concept of "source" is viewed in international comparison, legislation and case law are considerably divergent[200-201].

The concept of "source" has been defined as the place where the income-generating activity is located, referring to a state that is in some way or other connected to the production of the income in question or to a state where value is added to a good. However, the type of connection that establishes which state should be considered as the source of a certain income has not been generally described, if we exclude the definitions provided by the Commentary to the OECD Model Convention[202].

The problem of defining what "source" means could even lead to a sort of paradoxical result. A tax system resorting exclusively to source taxation, i.e. a purely territorial model, should be able, at least theoretically, to entirely disregard the concept

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[199] Pires, M., *International juridical double taxation of income*, Deventer-Boston, 1989, 134.
[200] Vogel, K., *Worldwide vs source taxation of income. A review and re-evaluation of arguments*, cited above, Part I, 223-226.
[201] Economists have attempted to shed some light when determining the source of the income from a theoretical point of view. They have essentially developed two different approaches: the so-called "supply approach", which identifies the source as the place where the factors generating the income operate, and the so-called "supply-demand approach", which states that profits are created through the interaction of supply (factors of production) and demand (where the market is located). The "supply approach" has historically been preferred, arguing that it would not be possible to assume a sufficient degree of involvement of the non-resident taxpayer in the economic life of a state that merely provides the market for goods and services. On the point, see, amongst others, López, E.E., *An opportunistic, and yet appropriate, revision of the source threshold for the Twenty-First Century tax treaties*, cited above, 8.
[202] As highlighted by Vogel, as far as business profits are concerned, a fundamental distinction must be made between countries allocating business profits according to a single comprehensive source rule, not distinguishing between different types of profits, and countries splitting business profits and allocating them according to their nature (e.g. profits derived from manufacturing, sales, loans, etc.). Common law countries traditionally tend to apply different source rules to different types of business profits. The United Kingdom, for example, still uses the quite broad concept of a "trade carried on within the UK", distinguishing between "trading with" and "trading within" the UK: only income from trading within the UK is considered domestic-source income and, in order to establish whether a trade is carried on within the UK, much attention is generally given to the place where the contract is made. On the contrary, in the United States the place where the contract is made is not generally conclusive. The range of criteria used for sourcing income further expands, if seen through an international comparison, with regards to passive income. For example, the criteria used to identify the source of cross-border interest, whether derived in business or not, include the residence of the debtor, the place at which the principal is made available, the place at which the principal is used, the place the payment of the interest is made and so on. On the point, see Vogel, K., *Worldwide vs source taxation of income. A review and re-evaluation of arguments*, cited above, Part I, 226.

of "residence", being taxation at source applicable both to residents and non-residents. However, some scholars have tried to identify the source of certain kinds of income by referring to the residence of the subjects who receives them. This has been the case, for example, with regards to dividends, interest and royalties, which, for example under treaties following the OECD Model Convention, are considered as produced in the territory of the state if paid by subjects who are residents therein. This consideration has led some authors to highlighting that switching to a purely territorial tax system without a comprehensive definition of what constitutes the "source" of an income would not allow to bypass the problem of establishing the residence of taxpayers, leaving residence at the centre of the debate in the exact way it has been in the analysis of worldwide taxation[203].

Notwithstanding all of the above, it is undeniable that, as it has been mentioned above, some states' income tax systems, especially with regards to corporations and juridical persons in general, are already inspired to "semi-territorial" models of taxation, while other countries are considering or have considered this possibility[204].

This is the case, for example, of France, where Article 209-I of the *Code Général des Impôts* provides that only income produced in France and income attributed to France's taxing jurisdiction by way of international conventions should be taken into account in the determination of the taxable base of juridical persons. Moreover, in general terms, corporations residing in the Netherlands are subject to tax on income wherever produced in the world. However, an exception is made for income produced abroad through permanent establishments distinctly and autonomously performing activities by way of their own organisation and structure. The same rule applies also for Switzerland and Australia. Article 217 of the Belgian *Code des Impôts sur le Revenus* provides that income produced abroad through a permanent establishment is partly exempted from taxation.

To a certain extent, it could be argued that even states adopting the exemption method in order to prevent international double taxation on dividends can be listed amongst the number of states looking at a territorial tax system[205].

Some other authors have even "stepped out" of the debate between which model between the worldwide and the territorial tax systems would be preferable, advocating

[203] Marino, G., *L'unificazione del diritto tributario: tassazione mondiale verso tassazione territoriale*, cited above, 873.
[204] In the United States, for example, a proposal made in 1993 in the context of the *Report of the National Commission on Economic Growth and Tax Reform* (better known as "Kemp Commission"), starting from the consideration of the high costs suffered by the U.S. Treasury in the operative administration of controls and enforcement, suggested the introduction of an entirely new regime mirroring a territorial tax model pursuant to which income produced outside U.S. territory by individuals or corporations should not be subject to tax.
[205] Marino, G., *L'unificazione del diritto tributario: tassazione mondiale verso tassazione territoriale*, cited above, 872.

that a comprehensive reform of international taxation would have to aim at a true alignment between economic activity and tax jurisdiction[206], which, however, as if of today, remains the object of a merely academic debate. Bearing this in mind, these authors have highlighted the need to look for new indicators of economic allegiance which would be able to adapt to the new economic context: on one hand, the inter-nation equity principles call for an equitable division of the worldwide tax base amongst the states involved to some extent in the generation of the cross-border income; on the other hand, the economic allegiance principle advocates for attributing taxing rights to the states that have contributed with their infrastructures and services to the generation of the income by the taxpayer. According to this view, the result would be a model based on formulas (so called "global formulary apportionment"), thus leaving behind the age-old residence-source paradigm[207].

Some have even suggested a solution that constitutes a compromise between worldwide taxation and taxation only at source, that is to say the so-called "schedular taxation"[208]. This theory is based on the assumption that worldwide taxation is not going to "survive" the process of deep integration amongst state and economies on a global scale, starting from which it has been argued that it might be necessary to switch to a system where all types of income are subject to separate taxation with lower tax rates being applicable to those income whose sources are of a more mobile nature.

Once we acknowledge the fact that countries are unlikely to agree to limit their tax jurisdiction to residence or source only, the next step should be to decide on the optimal method in order to prevent double taxation created by the interaction between the tax system of the source state and that of the state of residence.

While source countries have a practical advantage in assessing and collecting taxes, preventing double taxation is generally left to residence countries. There is, however, an international consensus that residence jurisdiction has primacy over passive income, while source jurisdiction has primacy over active income. This consensus is clearly reflected in the extensive tax treaty network of those states following the OECD Model Convention example. Nonetheless, even in treaties based on the UN Model

[206] Which, we should remember, was supposed to be the alleged main ambition of the OECD BEPS Project.
[207] López, E.E., *An opportunistic, and yet appropriate, revision of the source threshold for the Twenty-First Century tax treaties*, cited above, 13; Clausing, K., Avi-Yonah, R., *Reforming corporate taxation in a global economy. A proposal to adopt formulary apportionment*, Brookings Institution, June 1, 2007; Hellerstein, W., *The case for formulary apportionment income allocation in the 21st Century: the end of transfer pricing*, in International Transfer Pricing, 2005, 103.
[208] This opinion has been voiced, for example, by Tanzi. On the point, see Tanzi, V., *Taxation in an integrating world*, Washington, 1995, 133, as cited in Marino, G., *L'unificazione del diritto tributario: tassazione mondiale verso tassazione territoriale*, cited above, 869.

Convention, which generally favours developing countries, source states recognise the primacy of the states of residence of the taxpayer over passive income.

The topic of the possible implementation of a purely territorial tax system has been indirectly raised also in the OECD context, in occasion of the enactment of its reknown Base Erosion and Profit Shifting Project[209].

If it is certainly true, in fact, that the BEPS Project does not officially and directly aim at changing the existing international standards with regards to the the allocation of taxing rights[210], on the other hand it somehow indirectly responds to the change of balance of taxing powers between residence and source states generated by new business models and new transactions (e.g., electronic commerce), for example by means of Action 1, with the purpose to conduct a preliminary study of the fiscal challenges of the digital economy through questioning one of the ancient standards of the international tax system, i.e. the "permanent establishment threshold", which is conceived by some as the main responsible for the crisis of the current system of allocation of taxing rights[211].

The OECD BEPS Projects has the purpose to realign income taxation with the place where the economic substance of the transaction or the income-producing activity is[212], especially as a reaction to the progressive dematerialisation of wealth and to the new structures of multinationals, which contribute to the placement of certain categories of income in a sort of "fiscal limbo" which is far from the states' tax jurisdictions. It seems almost obvious to state, in fact, that economies, and especially financial sectors, are less and less tied to the territory, which makes the definition of territorial connecting factors between income and the taxing state considerably harder[213].

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[209] In brief, the OECD Base Erosion and Profit Shifting Project has been launched in 2013 by the OECD, with the sponsorship of G20 countries, and reached its conclusion at the end of 2015. The BEPS package provided fifteen "Actions" that were supposed to equip governments with the domestic and international instruments needed to tackle phenomena of base erosion and profit shifting and with the tools to ensure that profits are taxed where economic activities generating the profits are performed and where value is created.

[210] As it has expressly stated by the OECD itself in its 2013 *Action Plan on Base Erosion and Profit Shifting* (p. 11).

[211] Nonetheless, it has been correctly observed that the conclusions drawn by the OECD final report on Action 1 seems considerably "watered-down" if compared to the ambitious purposes declared at the beginning of the BEPS Project (the expression comes from López, E.E., *An opportunistic, and yet appropriate, revision of the source threshold for the Twenty-First Century tax treaties*, cited above, 12). It is essentially concluded that the implementation of potential solutions to the problem would be premature at the present stage and that, therefore, it would be more convenient to wait. It has also been highlighted that the temporary abandonment of this line of work could be explained mainly by referring to the likely resistance exercised by the United States in any dialogue intended to broaden source-based taxation, especially when the majority of the raised proposals would seem to target digital companies, mostly residents for tax purposes in the United States. On the point, see Spencer, D., *The OECD BEPS Project: tax challenges of the digital economy*, in Journal of International Taxation, 2014, 1, 30.

[212] OECD, *Action Plan on Base Erosion and Profits Shifting*, Paris, 2013, 13: "*a realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments*".

[213] Cassese, S., *La crisi dello Stato*, Rome, 2002, 37.

Starting from this general acknowledgment, the BEPS Project's Actions have focused, through their respective areas of concerns, on two different profiles which are both relevant for the purposes of the present research: the crisis of the concept of "residence" for tax purposes and the growing difficulty to define the location of the source of the income. Under this perspective, the purpose to draft rules to allow the state where the economic substance of the activity lies did not seem entirely defined, being it unclear whether the concept of "economic substance" should, in the OECD's opinion, evaluated with regards to the place where the source of the income is located (objective criterion) or with regards to the place where the taxpayer receiving that income is (subjective criterion)[214].

Nonetheless, the subsequent work of the BEPS Committees has shown a tendency, on the part of the OECD, to favouring a subjective approach, thus confirming the OECD's traditional preference towards taxation based on residence (worldwide taxation)[215]. However, it should be highlighted that the solutions advocated by the final reports of the BEPS Project are largely influenced by the declared purpose of the Project itself, i.e. to provide states with more effective tools to counter international tax avoidance practices, which makes them by nature not suitable to establish general rules able to have effect also beside such purpose[216].

6. Concluding remarks: tax territoriality as a limit to the economic integration of the European Union Internal Market.

What has been argued in the previous pages has essentially shown that, *rebus sic stantibus*, it would be quite difficult (if not impossible) to assert the existence of a binding principle or rule of tax territoriality enshrined in a source of international law, being it as a "general principle of law recognised by civilised nations" or as embedded in an international customary rule. With the consequence that sovereign states are generally free, in absence of any more specific rule (e.g. provisions of an international treaty) to exercise their taxing powers on foreign income as they see fit, being it theoretically possible and legitimate for states to enact legislation levying taxes even on income

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[214] Dorigo, S., Mastellone, P., *L'evoluzione della nozione di residenza fiscale delle persone giuridiche nell'ambito del Progetto BEPS*, in Riv. dir. trib., 2015, 3, 39. For a general overview of the (potential) consequences of the BEPS Project on the concept of "source" and on the debate on territoriality and allocation of taxing powers, see also López, E.E., *An opportunistic, and yet appropriate, revision of the source threshold for the Twenty-First Century tax treaties*, cited above, 6.

[215] Some authors have strongly criticised this approach, stating that the BEPS Project would be doomed to fail right from the start, being it based on an attempt to solve new problems through essentially traditional concepts.

[216] Dorigo, S., Mastellone, P., *L'evoluzione della nozione di residenza fiscale delle persone giuridiche nell'ambito del Progetto BEPS*, cited above, 74.

having its source in foreign territory and even in a dearth of connections with the taxing state. In simpler terms, state sovereignty implies jurisdiction to tax both residents and non-residents on income generated outside state territory.

For the same reasons, general international law does not seem to entail any explicit prohibition of juridical or economic international double taxation: sovereign states are generally free to consider a certain item of income as taxable without depending on the choices made by other states concerning that same item of income, exception being made for the case-by-case solutions adopted by states to counter the negative effects of double taxation on their businesses and enterprises, either unilaterally or through bilateral tax treaties. There is no hierarchical order which rules the claims extended by different countries on the same items of income; thus, any overlap stemming from the exercise of concurrent taxing powers on the part of different countries is, from an international tax law perspective, nothing but a "natural consequences" of the nature of international law itself and of the interaction of states which are all "equally sovereign"[217].

It follows that it does not seem possible, *rebus sic stantibus*, to come up with any uniform and homogeneous theory for the allocation of cross-border income and of states' taxing powers at international level, given that this hypothetical "model", in absence of a concerted action by states (which is quite difficult to imagine), would be deprived of any actual grounds to be based on.

This conclusion may be considered as acceptable in the international context, accepting that states are theoretically "boundless" when designing their domestic tax provisions with cross-border relevance; especially if we consider that, on a practical level, irrespective of the actual nonexistence of a binding principle of tax territoriality in a stricter sense, states show a certain degree of restraint in allocating their taxing powers, generally (but not always and not always with irreproachable results) searching for a reasonable link between them and the tax object.

It could be stated, therefore, that states generally tend to conform to criteria whose application resembles the mechanisms underlying the "principle of territoriality" as it stands in general international law, as a jurisdiction principle recognising a rights to legislate on the basis of a territorial connection between a state and a certain subject or object. In the international tax law practice, said link is, in fact, always of a "territorial" nature, where the term "territorial" is used *lato sensu*, referring both to "subjective

[217] The adoption of this assumption on the part of the Court of Justice of the European Union, as it will be shown in the following chapter of the research (see Chapter II, paragraph 6), has led to interesting results, in the context of the EU Internal Market, which will are going to be described as "parallel exercise of taxing powers doctrine".

territoriality", based either on residence, nationality or other subjective kinds of connection with the state's territory, and to "objective territoriality", based on the actual collocation of the income or the factors underlying the production of said income within the state's territory. International law, therefore, does not favour any of the two "criteria" mentioned above, i.e. worldwide taxation and strictly territorial taxation, leaving countries with the outmost freedom in shaping their tax systems and in the extension of their taxing powers, with the only limits to that freedom being those self-imposed by the states themselves, by entering into conventions for the elimination of double taxation.

The same, however, cannot be as easily accepted with regards to the European Union context, which is characterised - as known and as it will be further discussed in the following pages of the present research - by both general principles (e.g., the principle of non-discrimination, the fundamental freedom of movement of persons, goods, capital and services, the freedom of establishment, etc.) and specific provisions (directives and regulations, or even Treaty provisions concerning, for example, competition) that are aimed at ensuring, amongst other purposes, the proper functioning of the Internal Common Market.

This is even more true if we consider the fact that, in giving birth to the European Union, Member States have renounced to a part of their sovereignty by way of a transfer of competences, at least with regards to some specific areas, in favour of the Union itself. Therefore, if, in the international context, state sovereignty does not encounter any particular limitation besides those deriving from the (quite rare) international general principles of law and from bilateral conventions, the same reasoning cannot automatically apply in the context of the European Union.

Therefore, tax territoriality as described beforehand - or, rather, the absence of a binding principle of tax territoriality applicable to countries - amounting to the assertion of the outmost freedom for states (and Member States) to shape their tax systems and to levy taxes on foreign income without necessarily being limited to facts and events located within their national borders, constitute a potential hindrance for the effectiveness of the attainment of the purpose of integration of the European Internal Market. Even more so if we consider the negative effects that the boundless exercise of taxing powers on the part of the Member States can generate, in terms, for example, of juridical double taxation.

The question should, therefore, be which role could, and should, be played by tax territoriality in such a context. Once we abandon the idea that a hypothetical principle of

territoriality could be of any help to the process of integration of the European Market, we should ask ourselves whether or nor a more significant role could actually be played by tax territoriality (either "objective" or "subjective") interpreted as a criterion for allocating taxing powers amongst Member States in a way that does not conflict with fundamental principles of the Union or with the functioning of the Common Market.

In case of a positive answer, territoriality would, thus, go from constituting a potentially very significant hindrance to the realisation of a fully operative and functioning European Common Market from becoming a fundamental instrument at the service of European integration.

This is what will constitute the object of the following pages of the present work, where we will, first of all, attempt to verify, through an analysis both of the statutory provisions of the European Union in the field of direct taxation and of the most significant case law of the Court of Justice of the European Union on the point, the relevance and meaning of the "territoriality principle" for the purposes of European Union law, verifying if and how the domestic and international elaboration of the concept can be transposed in the European context. This analysis will serve as a necessary presupposition in order to understand, from a *de jure condendo* perspective, which of the two models described above (either worldwide taxation or "territorial" taxation or, possibly, none of them) better fits the European Union system and its fundamental principles and whether or not it could be possible to formulate a more general theory for the allocation of cross-border income (and taxing powers) in the Internal Market and for the taxation of non-residents on the part of the Member States.

CHAPTER II

TERRITORIALITY AND THE INTEGRATION OF THE INTERNAL MARKET: THE COURT OF JUSTICE'S ROLE IN A HYPOTHETICAL DESIGN OF A MODEL FOR THE CROSS-BORDER ALLOCATION OF TAXING POWERS WITHIN THE EUROPEAN UNION

1. European Union law and the consequent limitations to the Member States' sovereignty in the field of tax law: domestic fiscal provisions must bow to the functioning of the Internal Market.

As it has been shown in the first chapter of the present research, modern states are based on an absolute conception of state sovereignty, with each country being able to regulate, within the borders of their respective territories, all kinds of juridical relationship. At the international level, this peculiar trait is generally translated into the affirmation of the general independence of each national legal order with regard to the other ones; this character brings with it the necessary mutual recognition amongst countries of their independence towards one another. This kind of interaction between different legal orders on different levels leads, on one hand, to the "absolutization" and the exclusivity of national sovereignty considered *per se*, from a merely domestic and internal point of view, but also, on the other hand, to the "relativity" of that legal order which is inextricably bound to the recognition of the states' mutual independence, from an external point of view. The unavoidable consequence, for the purposes of the research, is that "external" juridical provisions may be recognised within each single state's legal order only if and insofar as said legal order allows.

As mentioned in the previous chapter, this paradigm has undergone a profound crisis with the introduction of a new and unprecedented legal order, i.e. the European Union, whose peculiar characters have deeply modified the contours of state

sovereignty, especially through legislative provisions, e.g. regulations, coming from a legislative body which is different from national parliament and which are directly applicable in the state's legal order irrespective of that state's will, but also as an effect of the existence of a judicial body interpreting European Union law and rendering judgements directly binding upon Member States.

The consequences on tax law cannot but be considerably disruptive.

As known, the current system for the distribution of competences between the European Union and Member States, created with the Maastricht Treaty, is based on the provisions of Article 5 TEU, according to which "*the limits of Union competences are governed by the principle of conferral*"[218] and "*the use of Union competences is governed by the principles of subsidiarity and proportionality*". As far as the principle of subsidiarity is concerned, the same Article 5 TEU clarifies that "*in areas which do not fall within its exclusive competence, the Union shall act only in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level*".

There is no need to dwell on the well-known and undisputed fact that taxation, both direct and indirect, falls within the scope of the competences which are instrumental to the attainment of the correct functioning of the Internal Market pursuant to Article 4 TFEU[219]: it is in light of this well-grounded assumption that part of the legal doctrine has argued that a genuine Internal Market can only be realised if the Member States' tax systems are integrated, at least sufficiently enough to remove the tax obstacles hampering the development of such Market and created by tax rules and practices that constitute discrimination, restrictions and, more generally, distortions[220]. However, if Articles 110-113 TFEU provide a basis for the positive integration and harmonisation of indirect taxes on the part of the European Union, the same has not been provided with

[218] The same Article 5, par. 2, TEU specifies that "*under the principle of conferral, the Union shall act only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein. Competences not conferred upon the Union in the Treaties remain with the Member States*".

[219] Union competence is based on the principle of conferral, pursuant to which the European Union has only the competences conferred on it by the Treaties (Article 5 TEU). The competences conferred upon the Union may be divided into three categories: exclusive competences (Article 3 TFEU), shared competences with "pre-emption" (which means that both the European Union and the Member States are competent, but whenever the Union chooses to exercise its competence, the Member States have to comply) and shared competences without "pre-emption" (meaning that the Union is only competent to support and coordinate the exercise of such competences by the Member States, without superseding such competences). Internal market as described in Article 4 TFEU falls within the group of the shared competences with "pre-emption".

[220] On the point, see, amongst others, Kemmeren, E.C.C.M., *Double tax conventions on income and capital and the EU: past, present and future*, in EC Tax Review, 2012, 3, 158; Sacchetto, C., *Member States tax sovereignty: between the principle of subsidiarity and the necessity of supranational coordination*, in Hinnekens, L., Hinnekens, P. (eds.), *A vision of taxes within and outside European borders*, Amsterdam, 2008, 804; Dorigo, S., *Residenza fiscale delle società e libertà di stabilimento nell'Unione Europea*, Padua, 2012, 10.

regards to direct taxation[221].

Unlike indirect taxes, direct taxes are not even referred to in the Treaties. Direct taxation, in fact, is left to the competence of the single Member States and the Treaty does not define, in general terms, the foundation of the states' taxing powers, which is seen by many as a direct consequence of the fact that, unlike national states, the European Union does not have any taxing powers of its own. Therefore, harmonisation of direct taxation at EU level seems to have a much smaller Treaty basis than harmonisation of indirect taxation[222].

This is also one of the reasons why the field of (direct) taxation is unanimously recognised as one of the most closely-guarded competences of the Member States, following the traditional opinion according to which "*les Etats ne pouvant se dessaisir de leur competences fiscales, sans disparaitre*"[223]. In the current state, Member States are generally free to determine whether they want to levy tax in the first place, what they wish to levy tax upon, the rate at which they wish to levy tax and - which is the most interesting aspect for the purposes of the present research - the criteria upon which they wish to base their tax jurisdiction. The reasons underlying this strong bond between States and their national sovereignty in the field of direct taxation are evident, especially if we consider that direct tax revenue contributes vitally to the public coffers of (almost) all Member States[224] and, consequently, to the choices that each Member State makes in terms of public spending.

Nonetheless, it is also true that, as a consequence of the establishment of the European Union, Member States's sovereignty in the field of direct taxation cannot but

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[221] It is for this reason that many authors have argued that the comparison between the number of "pure" European fiscal norms and the number of European norms which are relevant also for the purposes of tax law (e.g., competition, non-discrimination, state aids…) leads to the statement that the European Union legal order does not entail a complete system of fiscal norms, but rather a number of rules which have also effects on tax law, with concern only to some some sectors of the fiscal system of the single Member States. See, on the point, Roccatagliata, F., *Diritto tributario comunitario*, in Uckmar, V. (ed.), *Diritto tributario internazionale*, Padua, 2005, 1206; Aujean, M., *Le fonti europee e la loro efficacia in materia tributaria, tra armonizzazione, coordinamento e concorrenza fiscale leale*, in Di Pietro, A. (ed.), *Per una costituzione fiscale europea*, Padua, 2008, 9.

[222] The only legal basis for harmonisation of direct taxation would seem to be the general provisions on harmonisation, i.e. Articles 114 and 115 TFEU, and the complementary provision of Article 352 TFEU, which calls of appropriate unanimous measures by the Council "*if action by the Union should prove necessary to attain, within the framework of the policies defined in the Treaties, to attain one of the objectives set out in the Treaties, and the Treaties have not provided the necessary powers*". Since Article 114 TFEU, providing for qualified majority decisions on matters concerning the establishment and functioning of the Internal Market, does not apply to taxation, only Article 115 TFEU, requiring unanimity and calling for directives for the purpose of the approximation of national rules directly affecting the establishment or the functioning of the Internal Market, remains as a legal basis for the harmonisation of direct taxation.

[223] Berlin, D., *Droit fiscal communautaire*, Paris, 1988, 53, 101.

[224] This circumstance is clearly analysed and supported by a considerable amount of graphs and figures in Kingston, S., *The boundaries of sovereignty: the ECJ's controversial role applying internal market law to direct tax measures*, in Cambridge Yearbook of European legal studies, 2006, 1, 287.

bow to the fundamental Treaty principles and to the essential purposes of the European Union[225].

Even though the main reference, in the field of direct taxation, is, and should be, to the well-known non-discrimination principle and to the fundamental freedoms provided for by the Treaty on the Functioning of the Eureopan Union (free movement of persons, goods, workers, services, capital and freedom of establishment), on which there is certainly no need to dwell - provided that a more detailed analysis of the Court of Justice's interpretation of such freedoms in the context of direct taxation is to follow - it should be reminded that other Treaty provisions must inevitably be taken into consideration in order to fully understand the relevance of European Union law on the exercise of tax sovereignty on the part of the Member States.

First of all, it should be reminded that Articles 2 and 3 TEU establish the values and general objectives of the European Union, referring to concepts such as justice, solidarity and equality, while the three main political objectives of the Union are the establishment of an area of freedom and security, the attainment of a real Internal Market and of an economic and monetary union. Furthermore, Article 120 TFEU provided that the Member States, and not the European Union, shall conduct their economic policies with a view to contributing to the achievement of the above-mentioned objectives of the Union, whereas Article 121 TFEU provides that the Member States shall regard their domestic economic policies as a matter of common concern as far as European Union integration is concerned, coordinating with the Council with a view to reaching, through such policies, a higher level of harmonisation and to attaining the fundamental objectives to which the European Union aspires.

It is abundantly clear from all of the above, therefore, that the limits posed by the EU to the competences of the Member States in the field of taxation do not have eminently and essentially fiscal aims. On the contrary, they are, or they are supposed to be, exclusively functional to other objectives to which taxation must yield, such as the functioning of the internal market and competition. If we try to translate all of the above to a "constitutional language", the EU model of taxation is entirely devoted to the elimination of any economic interference hindering the proper functioning of the internal market. On the other hand, domestic taxation is generally modelled, according to modern constitutions, in order to achieve general social aims.

Therefore, even though, as it has been highlighted in the previous chapter of the

[225] On the point see, amongst others, Seer, R., *Le fonti del diritto comunitario ed il loro effetto sul diritto tributario*, in Di Pietro, A. (ed.), *Per una costituzione fiscale europea*, Padua, 2008, 31.

research, the states' fiscal sovereignty is theoretically absolute and that, therefore, each state is theoretically free to levy taxes on any economic event irrespective of where it occurs. However, in the context of the European Union, several limits are set both by way of secondary law and as an effect of the general principles stated in the Treaties, which means that the European Union context necessarily falls outside all paradigms described in the previous pages, with the European Union imposing principles and rules that largely influence the exercise of Member States' sovereignty in fiscal matters. Suffice it to say that, when a Member State decides to levy tax on an individual or a juridical persons which is not resident in its own territory, it must do so in compliance with a general non-discrimination principle, which is considerably different, as we will see, from the similar principle frequently mentioned in bilateral tax treaties.

A consequence of the coexistence of different national tax systems is that disparities inevitably exist amongst jurisdictions, which has distorting effects on investment, employment and establishment decisions. However, according to at least part of the case law of the Court of Justice of the European Union, as we will see in the following paragraphs, possible distortions resulting from mere disparities amongst tax systems do not fall within the scope of the free movement provisions in the Treaties. In other terms, according to the Court, obstacles resulting from disparities are different than obstacles resulting from discrimination, which occurs as a result of the rules of just one tax jurisdiction[226]: from this perspective, disparities are supposed nothing more than an inherent consequence of the sovereignty retained by Member States in direct taxation matters, occurring because there are discrete sovereign tax systems existing simultaneously, each having its own rules[227].

It follows from all of the above that tax harmonisation, in the context of the European Union, does not pursue aims of "fiscal justice" in the national meaning of a redistributive allocation of the burdens related to the financing of public expenditure on citizens. Taxation is not considered as a tool that is instrumental to the promotion of certain social purposes, but mainly as a neutral instrument that has to leave the

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[226] Douma, S., *The three Ds of direct tax jurisdiction: disparity, discrimination and double taxation*, in European Taxation, 2006, 11, 524.

[227] Weber, D., *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, in Intertax, 2006, 12, 588. See also Court of Justice, 23 April 2002, C-234/99, *Nygaard*: "*as it stands at present, Community law does not contain any provision designed to prohibit the effects of double taxation occurring in the case of charges, such as that in issue in the main proceedings, which are governed by independent national legislation, and, while the elimination of such effects is desirable in the interests of the free movement of goods, it may nonetheless result only from the harmonisation of national systems*". That, in general terms, sovereignty in direct tax matters rests with Member States, has been stated also in the *Bachmann* judgements (Court of Justice of the European Union, 28 January 1992, C-204/90, *Bachmann v. Belgium*): "*it is neither the intention of avowed aim of EU law to call into question the limits of any inherent power of taxation or to disturb the order of priority of the allocation of tax competences as between Member States, and, in the absence of EU harmonisation, the Court is not competent to interfere in the conception or organisation of the tax systems of Member States*".

realisation of the purposes set out in Article 2 of the Treaty only to market forces. From this perspective, all European Union interventions in the field are supposed to be aiming only at regulating the proper functioning of the Internal Market[228]. More specifically, the Internal Market requires a common commercial policy, a system ensuring the prevention of all possible distortions of competition and the approximation of the national laws of all Member States to the extent necessary for the functioning of the Internal Market[229]. In the words of the Court of Justice, the Internal Market "*involves the elimination of all obstacles to intra-community trade in order to merge the national markets into a single market bringing about conditions as close as possible to those of a genuine internal market*"[230].

All of the above-mentioned reasons have led a considerable number of authors to defining European Union tax law as "*une fiscalité de control*"[231]. This characteristic is to a large extent due to the fact that, as it has been correctly observed, whereas domestic tax systems are generally and constitutionally inspired by aims of a social nature (e.g., justice, redistribution of wealth, ability to pay, etc.), the interpretation and function of taxation in the European Union context are considerably influenced by the fact that, from a "constitutional" point of view, the Union pursues a free market economic model that requires the elimination, as far as possible, of all economic interferences[232].

In the European Union current context, therefore, taxation has gradually gone from constituting the very core of the idea itself of state sovereignty, the functioning mechanism through which the theoretical configuration of the primary relationships

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[228] Vanistendael, F., *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, in EC Tax Review, 2003, 4, 136. It is worth mentioning that, as reminded by Kemmeren, even though the terms "Internal Market" and "Common Market" are considered to be synonym, they are slightly different in terms of what they respectively imply for the European Union context. The "Internal Market" is characterised by the abolition of obstacles to the free movement of goods, persons, services and capital, while a proper "Common Market" requires a common commercial policy, a common system ensuring the prevention of distortions in the Internal Market and the approximation of the laws of each Member State to the extent that is deemed necessary for the functioning of the Common Market. In other terms, according to Kemmeren, "*it is essential that the common market be analogous in nature to the domestic market of a single state*". See Kemmeren, E.C.C.M., *The internal market approach should prevail over the single country approach*, in Hinnekens, L., Hinnekens, P. (eds.), *A vision of taxes within and outside European borders*, The Hague, 2008, 557. On the same point, see also Cordewener, A., *The prohibitions of discrimination and restriction within the framework of the fully integrated Internal Market*, in Vanistendael, F., *EU freedoms and taxation*, Amsterdam, 2006, 4.

[229] In the Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on "Double taxation in the Single Market", COM(2011)712, 11 November 2011, the Commission has highlighted that it is part of its Europe 2020 strategy to attain the removal of all remaining obstacles to the integration of the Internal Market, highlighting, in particular, that double taxation, as the result of an inconsistent interaction of different domestic tax systems in the European Union, is a major impediment to this purpose.

[230] Court of Justice of the European Union, 9 February 1982, 270/82, *Polydor*; Court of Justice of the European Union, 5 May 1982, 15/81, *Gaston Schul I*, as quoted by Kemmeren, E.C.C.M., *Double tax conventions on income and capital and the EU: past, present and future*, cited above, 158.

[231] Berlin, D., *Droit fiscal communautaire*, cited above, 53.

[232] Sacchetto, C., *Member States tax sovereignty: between the principle of subsidiarity and the necessity of supranational coordination*, cited above, 804; the Author defines EU taxation as "*functional taxation*". For an overview of the most recent challenges European Union tax law faces, see Fregni, M.C., *Problemi e prospettive dell'Unione fiscale europea*, in Rassegna Tributaria, 2013, 5, 1061.

between peoples and governments, the cornerstone of the fundamental balancing of interests between the interests of the state as a "collective entity" and the interests of the single citizen, to being considered as a phenomenon that should be "contained" and limited[233] in order to protect and promote competition and the fullest possible exercise of the fundamental freedoms of movement and in order to prevent obstacles and barriers to the free economic activities of EU citizens[234].

One of the purposes of the present research is, therefore, precisely to understand whether or not this is an unavoidable conclusion, directly following from the inherent nature of the European Union and of the relationship between the Union and its Member States, or rather if this conclusion is the result of a merely contingent situation and whether the European Union has the means to come up with a model of (cross-border) taxation that can actually ensure a higher degree of integration of the Internal Market while, at the same time, pursuing such as equality and redistribution of wealth. In other terms, we will try to verify whether or not it is actually possible to "turn the tables" on the conception of "taxation" from the European Union point of view, shifting from the current "negative" perspective, in which the fiscal phenomenon is conceived as just something that must be contained in order to ensure the Internal Marker purpose, to a new "positive" perspective, in which taxation can become a fundamental tool for the implementation of the Internal Market and the realisation of the authentic purpose of the European Union.

This is one of the ultimate purposes of the analysis that is conducted in the present research, starting from the acknowledgement of the fundamental role that territoriality plays in this study. In the following pages, therefore, we will conduct an analysis on how the Court of Justice of the European Union has interpreted and construed the concept of territoriality in its case law on direct taxation, from the specific perspective of the jurisprudence on the taxation of non-residents: more in detail, we will examine how the Court has transposed the international law concept of territoriality, notwithstanding all the uncertainties surrounding it that were described in the previous chapter, sometimes to justify restrictions to the freedoms of movement of non-resident EU citizens, sometimes to force Member States to modify their tax measures (and the borders of their tax jurisdictions) in order to comply with the need to ensure the implementation of the fundamental freedoms, of the principle of non-discrimination

[233] Boria P., *L'anti-sovrano. Potere tributario e sovranità nell'ordinamento comunitario*, Turin, 2014, *passim*.

[234] According to part of the legal scholarship, assuming the Internal Market as the central and paramount benchmark on which to analyse the compatibility of Member States' tax laws with European Union law clashes with the choices made by single Member States' constitutions, granting taxation a fundamental role in the processes of social transformation and progress.

and, ultimately, of cross-border neutrality.

It has been convincingly observed that, in the European Union context, the Court of Justice's case law has provided an essential impulse to a phenomenon of convergence of domestic laws, by way of a process of "circulation" of general principles developing in two opposite directions: from national legal orders towards the EU legal order and from the EU legal order to national legal orders, in a sort of osmosis of principles by way of which the two legal orders reciprocally influence one another[235].

This, however, does not appear to be entirely true with regards to the principle/criterion of territoriality, which has not yet reached a definite understanding in the elaboration of the Court of Justice of the European Union, which creates a certain degree of confusion with regards to the implication of such a concept also on a domestic scale. This is certainly due in part to the fact that, in light of the reasons described in the previous chapter, it is considerably difficult to consider the concept of "territoriality" as an actual principle, at least in the field of international tax law (to which, however, the Court makes explicit references whenever mentioning the "principle of territoriality"). On the other hand, the Court of Justice's case law has not certainly helped in the clear definition of what should be meant by the concept of "territoriality" and of which relevance said concept should have for the purposes of an "European tax law", with an approach to the topic which, as it will be shown, has treated "territoriality" in a very inconsistent manner through the years. This, however, is not a subject that can be treated lightly, since the confusion on the concept, meaning and implications of the principle of territoriality, as we will see, leads to a vagary approach to the topic of what a Member State can and cannot do in shaping the borders of its tax jurisdiction.

Before proceeding in the analysis of the topic, it should be highlighted that the present research will limit itself to the aspects of "territoriality" that are connected exclusively to direct taxation and will not concern itself with the (quite different) elaboration of the concept applied to the field of indirect taxation and, especially, VAT. The main difference being, in fact, linked to the fact that Member States, as seen above, have not enacted any complete transfer of sovereignty to the European Union in the field of direct taxation, whereas such a transfer has been put in place with regards to indirect taxation. Which essentially means that European Union law encompasses a definition and an elaboration of its own on the point of "territoriality", but that such an analysis can be considered as limited only to the field of indirect taxation. With regards to direct

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[235] Cipollina, S., *I confini giuridici nel tempo presente. Il caso del diritto fiscale*, cited above, *passim*.

taxation, on the other hand, it is not possible to (immediately) find an "European Union concept of territoriality".

The question, therefore, should be whether or not such a hypothetical concept can be drawn from the analysis criteria for the allocation of taxing powers that the Member States have had to put in place (both as the effect of the Court of Justice's jurisprudence and of EU secondary law) in order to comply with the fundamental Treaty freedoms. In other words, we should verify the possibility of coming up with a "European concept of territoriality" drawn from the elaboration of the common principles forming part of the national legal systems.

Which also leads to the (obvious) conclusion that (the analysis of) European Union law will come to relevance with regards only to its application to cross-border items of income, whereas the "domestic" definition of territoriality overlooks the specific relevance of transnational income, given that the choice between "source" or "residence" as fundamental territorial criteria for the definition of the state taxing powers' scope applies irrespective of an item of income having a purely domestic or a cross-border nature.

1.1. The peculiarity of European Union provisions and principles on taxation: tax rules without a taxing power.

It has been highlighted above that the European Union legal order leans towards a "negative" or "subtractive" of the single Member States' taxing powers. The European Union, in other words, calls upon itself some of the choices in the field of taxation, subtracting them from the competences of the single Member States, thus enacting a transfer of taxing powers which removes, or limits, part of national sovereignty. These choices, however, have not brought to a positive regulation of direct taxation (yet), but rather have led to limitations to national sovereign taxing powers.

It is certainly true, however, that the European Union, as it currently is, is not easily reconciled with an idea of "sovereignty", being it that it lacks any ascending conception of power (with a very limited role of democratic representation) and any specific connection to a territory in the traditional meaning of the word. Currently, therefore, the European Union's role in direct taxation is essentially to limit the exercise of national sovereign powers so as to lead to a composition of the various interests at play (state interest, enterprises, individuals…) based on "market concepts": this is, according to some, a vision of taxes that answers only to the need of ensuring

competition and, more in general, the functioning of the market.

It has already been highlighted that, from this perspective, taxing powers lose, at least as far as European Union law is concerned, all of their "social" elements and all purposes of redistribution of wealth, being it reduced to a mere instrument of collecting state resources which has, furthermore, to be contained as not to hinder the development of the Internal Market and, ultimately, cross-border neutrality.

According to some, this character is an unavoidable consequence of the peculiar role of the European Union and, more specifically, of the fact that the European Union establishes fiscal provisions and principles without having any corresponding fiscal power of its own and no "territory" on which to exercise it. Many EU provisions deal with taxation, even though they have never conferred any power to levy taxes upon the European Union and they have never had the aim to raise money to finance the expenses of the EU. The Union does not have its own taxes, therefore it also lacks any administrative power with regards to taxation: tax collection is left exclusively to single Member States' financial administrations, which, then, contribute part of the resources collected to the European Union's coffers.

The fact that direct taxation is generally left to the competence of the single Member States and that the Treaty does not define any foundation of the Member States' taxing powers, can also be interpreted as a direct consequence of the fact that, unlike national states, the European Union does not have any taxing powers of its own. In fact, one of the most peculiar traits of the European Union order lies in the way the Union itself is financed, through a "hybrid" system that is partly based on contributions from all member States (which is typical of all international organisations) and partly based on the collection of the Union's own resources (which is typical of all sovereign states)[236]. However, all of the Union's own resources are not directly linked to any exercise of taxing sovereignty by the Union itself, all of them being contributions which are

[236] Originally, the EC Treaties provided for financial contributions to the EC institutions to be distributed amongst single member States on the basis of political criteria, that is to say depending on the role that each State played in the institutions also in terms of voting rights. In 1970, a treaty was signed in Luxembourg modifying these rules, thus entailing the use of own resources instead of financial contributions from States. The system underwent another change in 1988, when the Council decided that the budgetary needs of the Community would have better been met through an enlargement of the list of own resources. Nowadays, the Union relies upon four types of own resources: customs duties, contributions from agricultural activities, part of the tax revenue from the collection of VAT by member States and a contribution which all member States must pay to the Union on an annual basis (which is generally set aroung 1% of the State's GDP). On the subject, see Boria, P., *L'anti-sovrano - Potere tributario e sovranità nell'ordinamento comunitario*, cited above, 46. Article 311 TFEU allows the Council, unanimously, in accordance with a special legislative procedure and after consulting the European Parliament, to adopt a decision about the system of own resources of the Union, possibly establishing new categories of own resources or abolishing an existing category. That decision shall not, however, come into effect until it is approved by the Member States in accordance with their respective constitutional procedures. On the point, see also Elwes, S., *The Internal Market versus the right of Member States to levy direct tax. A clash of fundamental principles*, in Intertax, 2013, 1, 16.

essentially collected and then “paid” by all single member States.

From the European Union’s lack of own taxing powers follows that the Union cannot, as it is, exercise any exclusive competence in fiscal matters, having to assume a role essentially limited to the coordination and regulation of national fiscal policies and tax measures. It is also true, on the other hand, that, *rebus sic stantibus*, European Union institutions do not have any particular interest in the collection of fiscal resources, since the matter is left to the Member States. From this perspective, the link between taxes and public expenditure currently leans towards national taxing powers, with the competence of the European Union being given a considerably limited role, at least on paper. This is one of the consequences following from the implementation of the principle of subsidiarity.

This characteristic of the European Union legal order, according to some, brings to a friction with the fact that the fiscal phenomenon constitutes the object of much attention (but quite less regulation) on the part of the European Union, coherently with the purpose of building a truly functioning Internal Market, with no barriers.

Taxation is, therefore, inherently linked to the attainment of the European Union’s purposes, but, since taxation is not conceived (yet) as a tool for the collection of financial resources which are essential for the existence and development of a European community, being it that the European Union itself does not have any actual taxing power, taxation is interpreted and treated as an element which is able to cause potential distortions to competition and to the exercise of fundamental freedoms.

It is light of this reason that part of the legal scholarship[237] has argued that the lack of any fiscal power upon the European Union cannot but influence the “constitutional” definition of the taxing powers in terms that are substantially different (and to a certain extent incompatible): given that there is no need, from the European Union perspective, to regulate the fundamental values of the community in relation to individual citizens when it comes to taxation, the European Union “ensemble” of values cannot but be only connected to the purposes underlying European integration, with a “negative” conception of taxation. The consequence is that the EU discipline of taxation is inherently shaped on values which are generally far from the Member States’ fiscal interest.

1.2. The European Union’s “negative” approach to direct taxation: the (much criticised) Court of Justice’s role in the development of an European tax law.

[237] Boria, P., *L’anti-sovrano - Potere tributario e sovranità nell’ordinamento comunitario*, cited above, *passim*.

Article 115 TFEU allows the Council, acting unanimously in accordance with a special legislative procedure and on a proposal from the Commission and after consulting the European Parliament, to issue directives for the approximation of Member States' laws directly affecting the establishment or functioning of the Internal Market[238]. However, all actions in the field of direct taxation under Article 115 TFEU find a fundamental obstacle in the requirement of unanimity and on the fact that, to put forward a proposal for a directive, the Commission must demonstrate that a certain distortion caused by direct taxation (or, better, by the interaction of national direct tax laws of Member States) implies an actual obstacle for the implementation of the Internal Market.

The combination of the need for unanimity and of the reluctance of Member States in accepting limitations to their taxing powers in the field of direct taxes has led to an almost complete "paralysis" of all forms of positive integration of direct taxation in the European Union context[239-240].

Scholars are essentially unanimous in stating that, as a consequence of such a "paralysis" the Court of Justice of the European Union has been the institution that, more than all others, has driven forward the process of an European tax integration[241]. The efforts of the Court of Justice stand out in contrast to the lack of political will on the part of the Member States to reach a wide-ranging harmonisation of taxation by way of legislation. On the basis of the fundamental Treaty principles of non-discrimination, free movement of workers, free movement of goods, freedom of establishment, free movement of services and free movement of capital, the Court has elaborated general assertions and criteria to which Member States must comply. However, the Court of Justice case law on direct tax matters suffered a great deal of criticism by tax scholars for its apparent lack of clear tax policy objectives. Academics generally agree in recognising

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[238] On the point, see Commission Communication to the Council and the European Parliament, *The contribution of taxation and customs policies to the Lisbon strategy*, COM(2005)532, where it is stated: "*several aspects of the functioning of national tax systems have negative effects on market integration or prevent the advantages of a single market from being fully exploited. The removal of such obstacles would allow businesses to make sounder economic choices based on the productivity of factors and are less distorted by the influence of certain extra costs*".

[239] Pistone, P., *Expected and unexpected developments of European integration in the field of direct taxes*, in Intertax, 2007, 70. For a complete summary of the European Union initiatives in the field of direct taxation and of the slow process leading up to the current situation, from the 1996 Ecofin held in Verona to current days characterised by a "soft law approach" on the part of the Commission, see Aujean, M., *Le fonti europee e la loro efficacia in materia tributaria, tra armonizzazione, coordinamento e concorrenza fiscale leale*, cited above, 17.

[240] It should be noted that one of the topics discussed during the Intergovernmental Conference of 2003-2004 was the possibility to replace the need for an unanimous vote with a procedure based on qualified majority in some fields concerning taxation and relevant to the functioning of the Internal Market, such as administrative cooperation, the fight against tax fraud, tax evasion, free movement of capital, measures concerning corporate tax bases and environmental taxation. See Commission Recommendation to the Intergovernmental Conference, COM(2003)548. On the point, see also Aujean, M., *Le fonti europee e la loro efficacia in materia tributaria, tra armonizzazione, coordinamento e concorrenza fiscale leale*, cited above, 12.

[241] Vanistendael, F., *The ability to pay principle in the EU legal order*, in Salvini, L., Melis, G. (eds.), *L'evoluzione del sistema fiscale e il principio di capacità contributiva*, Padua, 2014, 210.

the "judge-made harmonisation" of direct taxation in the context of the European Union as just the *pars denstruens* of the harmonisation process, arguing that a harmonisation built on the removal of national provisions does not (and cannot) provide the systemic coherent view and the global approach that statutory law could provide. And that is mainly due to the fact that the Court uses tools such as the non-discrimination principle, which, according to many, was established in order only to protect the citizens of a Member State from the discriminatory provisions of another Member State.

It is commonly accepted in the Court of Justice's jurisprudence that, because there are no general European Union rules on direct taxation and on the allocation of taxing powers amongst Member States, the power to determine the criteria for the levying of taxes with a view to defining fiscal jurisdiction and avoiding double taxation lies with the Member States, which are free to define, unilaterally or by way of their double taxation conventions, the connecting factors for the allocation of taxing powers and the structure of their tax systems. The fact that each of the Member States has sovereignty over whether and how to levy direct taxes means, of course, that there are twenty-seven discrete and different direct taxation systems interacting in the context of the European Internal Market, with all the consequent advantages and disadvantages for taxpayers arising from the disparities created by the implementation of such rules[242].

It follows that, according to the Court of Justice's case law, Member States may choose to shape their tax systems following a model of source taxation not only for non-residents, but for residents as well, designing their tax jurisdictions so as to cover only domestic-source positive and negative items of income. The Court of Justice of the European Union has confirmed that the use of these criteria by Member States in order for them to establish their tax jurisdiction is compatible with EU law (*Gerritse*, *De Groot*, *Saint Gobain, Futura*). Nonetheless, it also goes without saying that, according to consistent case law of the Court of Justice, when exercising the taxing powers so allocated, Member States must not ignore or breach European Union law[243]. Therefore, even limitations to the Member States' tax jurisdictions, either self-imposed or deriving from bilateral agreements, may be found as not compliant with European Union law when tested against the EU citizens' right to unrestricted exercise of the Treaty freedoms.

The Court of Justice's case law has to a large extent interpreted fundamental freedoms as expressions of the more general principle of non-discrimination[244]. Especially

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[242] Weber, D., *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, cited above, 586.
[243] Greggi, M., *Revisiting Schumacker: the role of limited tax liability in EU law*, cited above, 52.
[244] Garcia Prats, F.A., *EC law and direct taxation: towards a coherent system of taxation?*, Report to the EATLP Annual Conference, Helsinki, 2007, 3, where the Author critically analysed the Court of Justice's case law in the field of

in earlier times, the jurisprudence of the Court of Justice interpreted the Treaty provisions on freedom of movement as imposing on Member States a prohibition of discrimination towards citizens of different Member States. Subsequently, the Court of Justice partially modified this approach, thus stating that Treaty provisions on freedom of movement of persons, capital, goods, services and establishment not only prohibit discriminations against non-resident EU citizens (interpreted as indirect discrimination based on nationality), but also prevent Member States from establishing all other sorts of restrictions, towards both residents and non-residents, hindering or otherwise having dissuasive effects on the exercise of the freedoms of movement granted by the Treaty[245].

This approach finds its ground on the paramount relevance of market equality in the European Union context. Fundamental freedoms are the expression of the need for Member States to grant equal opportunities and equal initial conditions to all economic actors within the Internal Market, irrespective of their residence or of the place where the income is produced. It has been correctly observed that this general principle does not automatically translate into an "absolute" principle of equality in the European Union context, which, as far as taxation is concerned, could, at least theoretically, be attained only by way of the unification of all Member States' tax laws, but into a more "limited" meaning, i.e. the possible extension of domestic provisions to non-resident subjects or to the taxation of income produced in foreign territory[246].

On the other hand, authors have argued that competition within the Internal Market should not be interpreted not only as between enterprises and economic operators, but also as amongst Member States, with the consequent need to eliminate all distortions of the proper functioning of the Market from whatever source they should come[247]. Applying such concepts to the field of tax law, according to this model, Member States should replace their tax models based on capital export neutrality (or "internal neutrality") with new models based on capital import neutrality (or "external

direct taxation, stating, *inter alia*, that "*Member States are put in a difficult situation: no matter what they do, they end up discriminating*".

[245] Bizioli, G., *Il principio di non discriminazione*, in Di Pietro, A., Tassani T. (eds.), *I principi europei del diritto tributario*, Padua, 2013, 231; Cordewener, A., *The prohibitions of discrimination and restriction within the framework of the fully integrated Internal Market*, cited above, 12.

[246] Bizioli, G., *Il principio di non discriminazione*, cited above, 207. The Author also highlights that the principle of non-discrimination in the field of tax law is applied to the tax provisions of one Member State only, obliging that Member State to grant equal treatment to purely domestic situations and to cross-border situations, with the consequent elimination, within one single legal order, of different treatment, leaving unadulterated the disparity of treatment deriving from the implementation of tax laws belonging to a plurality of different legal order, with an unavoidable "fragmentation" of the Internal Market. This point will be further developed in the following pages of the research, with the analysis of the Court of Justice's so-called "parallel exercise doctrine".

[247] Graetz, M., *Taxing international income: inadequate principles, outdated concepts and unsatisfactory policies*, in Tax Law Review, 2001, 261.

neutrality")[248], i.e., amongst other measures, replacing worldwide taxation with territorial taxation (taxation at source). It has also been recognised, however, that the problem with the adoption and implementation of such a model would be that a strictly territorial tax system would preclude the effective compensation of the losses suffered in a Member State with the income produced in another Member State by a taxpayer who is resident of the latter Member State, with the consequent risk of hindering the exercise of the fundamental freedom of establishment.

Even more so if we consider that the European Commission has repeatedly confirmed, with regards to direct taxation, that there is "*no need for an across the board harmonisation of Member States' tax systems. Provided they respect EU rules, Member States are free to choose the tax systems they consider most appropriate and in accordance with their preferences. In addition, any proposal for EU action in the tax field needs to take into account the principles of subsidiarity and proportionality. Many tax problems require only the better coordination of national policies*"[249]. A similar statement has been voiced many times by the Court of Justice of the European Union, which, for example, in the *Bachmann* judgement[250], has recognised that "*it is neither the intention or avowed aim of EU law to call into question the limits of any inherent power of taxation or to disturb the order of priority of the allocation of tax competences as between Member States, and that, in the absence of EU harmonisation, the Court is not competent to interfere in the conception or organisation of the tax systems of Member States*".

Part of the scholarly opinion, therefore, has strongly criticised the Court, stating that is has no expertise in the field of international allocation of taxing powers and that sometimes it makes errors in tax law, the main one being that it incorrectly assumes the non-existent power to interpret bilateral tax treaties and national tax law. Some argue that the Court does not have any legal basis in EU law for any competence to interpret bilateral treaties between the member States. Nevertheless, in cases such as *Wielocks*,

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[248] Kemmeren, E.C.C.M., *Principle of origin in tax conventions. A rethinking of models*, citd above, 69; Weber, D., *Is the limitation of tax jurisdiction a restriction of the freedom of movement?*, Paper for the annual conference of the European Association of Tax Law Professors, Helsinki, 7-9 June 2007, 5.

[249] Commission Communication to the Council, the European Parliament and the Economic and Social Committee, COM/2001/260, *Tax policy in the European Union: priorities for the years ahead*. This was one of the few really comprehensive tax policy documents issued by the Commission, where the Commission identified three aims for taxation in the context of the Internal Market. More specifically, according to the Commission, national tax systems should be more transparent and simple, contribute to an effective functioning of the Internal Market and shift to lower rates and broader bases. Generally speaking, however, since positive integration requires unanimity, which is difficult to attain, the Commission aims at maximising the effects played by the "negative harmonisation" resulting from the case law of the Court of Justice of the European Union, closely monitoring the Court's judgements on Treaty freedoms and issuing soft law communications on how these judgements should be understood, inviting Member States to consequently adapt their tax laws and administrative practices to comply with such interpretation (e.g. with regards to exit taxation, tax incentives for R&D, cross-border loss relief, levying and crediting of withholding taxes on cross-border dividends, abuse of law in the area of direct taxation, etc.) and, if necessary, initiating infringement proceedings against non-compliant Member States.

[250] Court of Justice of the European Union, 28 January 1992, C-204/90, *Bachmann v. Belgium*.

X&Y and *Van der Grinten*, the Court undertook such interpretation of bilateral tax treaties or even of national tax law[251]. This *ultra vires* interpretation of tax treaties and tax law shows a limited understanding of the issues, of their political importance and of the mechanism of tax base allocation and elimination of double taxation[252].

From the viewpoint of the analysis of EU case law, scholars have pointed out that, as an effect of the Court of Justice's intervention, the border between the competence of the EU and of the Member States has been shifted, with a *de facto* modification of the division of competences between the EU and the single Member States. Some scholars, in particular, have criticized the role played by the Court arguing that it has led to a violation of the principle of subsidiarity. More in detail, according to them, there is no concluding clear link between fundamental freedoms and national tax provisions because the Treaty principle do not make any reference to tax matters, thus concluding that the extension of the scope of application of the fundamental freedoms to tax matters was a mere creation of the Court of Justice.

1.3. Beyond the "discrimination-restriction" binomial: "overall approach" vs. "per country approach".

Notwithstanding the position that may be held as regards the "fairness", legality and political implications of the Court of Justice's intervention in matters concerning direct taxation, it has been traditionally observed that the Court of Justice's case law on direct taxation, discrimination and the compatibility of national fiscal measures with the Treaty freedoms may be distinguished into two different groups: a group of judgements where the Court has analysed the fact pattern taking into account elements limited only to the legal order of one single Member State (so-called "per country approach") and a different group of judgements where the Court has examined factual and juridical elements from a global perspective (so-called "overall approach")[253-254].

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[251] Wattel, P.J., *Red herrings in direct tax cases before the ECJ*, in Legal Issues of Economic Integration, 2004, 2, 81.

[252] A clear picture of the problem has been given by Commissioner Kovács in his speech "*The Future of Taxation*", 2007, London, available online.

[253] Bizioli, G., *Balancing the fundamental freedoms and tax sovereignty: some thoughts on recent ECJ case law on direct taxation*, in European Taxation, 2008, 135. For a brief description of the evolution and meaning on the "overall approach" of the Court of Justice, see Vanistendael, F., *The ECJ at the crossroads: balancing tax sovereignty against the imperatives of the Single Market*, in European Taxation, 2006, 9, 413; Cougnon, J.M., *Plea for a multilateral approach in the judgements of the European Court of Justice*, in EC Tax Review, 2011, 4, 179.

[254] AG Geelhoed, for example, is amongst the supporters of the "overall approach". In his Opinion on the *Test Claimants in Class IV of the ACT Group Litigation* case (Court of the European Union, case C-374/04), he has observed that "*the combination of home State and source State obligations under the free movement provisions should properly be seen as a whole, or as achieving a type of equilibrium. Examination of the situation of an individual economic operator in the framework of just one of these States - without taking into account the Article 43 EC obligations of the other State - may give an unbalanced and misleading impression, and may fail to capture the economic reality in which that*

The question of the dialectical relationship of these two very different approaches of the Court of Justice to the matters concerning direct taxation, and the consequent problems deriving from the fact that, as of today, there is not a definitive prevalence of one approach over the other - with the following difficulties, for Member States, to adapt to this level of uncertainty in drafting their national fiscal measures - is far from being exclusively doctrinal or merely theoretical. It is clear, in fact, that the decision on whether to analyse the field of direct taxation from one or the other point of view has very practical and potentially disruptive consequences on the Member States' freedom to legislate and to exercise (or not exercise) their tax jurisdiction, as the analysis of the Court's case law that will follow is going to demonstrate more in detail.

Suffice it to say, here, that applying the "overall approach" to the implementation of the principle of non-discrimination implies the extension of the comparison to a plurality of legal orders and, therefore, to a plurality of tax systems, deciding on the position of a taxpayer from the point of view of operations in a fully integrated Internal Market: restrictions and discriminations are decided not only on the basis of the effect of the rules that are in place in a single separate tax system, but also on the basis of the integration of both tax systems of the Member State of residence and the Member State of source[255]. The result of this approach is that the boundaries imposed on Member States are constituted not only of the prohibition of discrimination against non-residents (or against residents with foreign activities) if compared with residents, but also of the need to ensure that non-residents (or residents with foreign activities) are not subjected to heavier burdens than those suffered by residents as a consequence of the combined effect of two (or more) tax systems[256]. Which considerably clashes with the "parallel exercise of taxing powers doctrine" formulated, for example, in cases such as *Schempp* and *Kerckhaert Morres*.

The supporters of the "overall approach" argue that a "per country approach" would be inconsistent with the aim of the realisation of a proper Internal Market, being, on the contrary, essential that the European Internal Market be analogous to the domestic market of a single state. Therefore, according to this view, the Court of Justice

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operator is acting". This position has been confirmed in AG Geelhoed's Opinions on the *Kerckhaert Morres* and *Denkavit* cases as well.

[255] Vanistendael, F., *Le nuove fonti del diritto ed il ruolo dei principi comuni nel diritto tributario*, in Di Pietro, A. (ed.), *Per una Costituzione fiscale europea*, Padua, 2008, 120; Vanistendael, F., *The ECJ at the crossroads: balancing tax sovereignty against the imperatives of the Single Market*, cited above, 414.

[256] Cordewener, A., *The prohibitions of discrimination and restriction within the framework of the fully integrated internal market*, in Vanistendael, F. (ed.), *EU freedoms and taxation*, Amsterdam, 2006, 35; Lehner, M., *Tax consequences resulting from the application of the non-restriction principle in the areas other than taxation: distinction between discriminatory and non-discriminatory restrictions*, in Vanistendael, F. (ed.), *EU freedoms and taxation*, Amsterdam, 2006, 47.

should, in its judgements, take into account not only the domestic tax law of a Member State, but also the relevant double taxation conventions concluded by that Member State with the other Member State involved and also the tax law of the latter[257].

On the other hand, many have criticised the "overall approach" as hindering the effective exercise of the Member States' sovereign powers, observing that inherent to tax sovereignty to levy taxes is that the exercise of this sovereignty does not depend on how another country acts with regards to taxation: a Member States, in other terms, may decide itself how to structure its own tax system in a manner that is not dependent on the behaviour of any other country[258].

In the evaluation of the question on which of the two approaches should be considered as more suitable to the attainment of a proper functioning of the Internal Market, it should also be considered that, on one hand, the "overall method" is certainly more careful to the actual reality of the case, allowing to take into account the practical consequences arising from the tax provisions at issue on the taxpayer concerned, not only from a domestic perspective, but from a supranational and "truly European" point of view as well: it is certainly the method which, more than any other, aims at considering the European Union as a true Single Internal Market. However, on the other hand, this, which could be considered as one of the points of strength of the "overall approach", is also one of the most relevant limits of the method: in fact, taking into account the actual situation of the taxpayer concerned and all the practical consequences played by the interaction of all national systems at play cannot but imply the adoption of a "case-by-case approach", thus impairing the development of general principles and rules that could be followed by Member States in the designing of their fiscal jurisdictions and their tax provisions concerning cross-border circumstances and, therefore, hindering legal certainty and exposing national treasuries to considerable risks.

It follows from the case law of the Court of Justice of the European Union that the attainment of a "common market" which is authentically "common" is not just a means, but it must be considered as being, in itself, amongst the fundamental aims of the European Union. From the above, several commentators have drawn the conclusion that the most appropriate reasoning to be used by the Court when analysing potential

[257] Kemmeren, E.C.C.M., *The internal market approach should prevail over the single country approach*, cited above, 562. For a contrary opinion, see Lang, M., *The Marks & Spencer case. The open issues following the ECJ's final word*, in European Taxation, 2005, 2, 57; Weber, D., *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, cited above, 585.
[258] Weber, D., *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, cited above, 602.

restrictions or discriminations put in place by member States' national tax provisions is the so-called "overall approach"[259]. By way of this reasoning, the Court should not only take into account the domestic tax law of a member State, but also all relevant double taxation conventions which that State has entered into with other countries, as well as the domestic provisions of all other involved member States.

Statistically, the Luxembourg judges have more frequently applied the "overall approach" rather than its opposite. In *Schumacker*, for example, as we will see, the Court took into account the overall result following from the application of the tax rules in both the state of residence and the source state in order to assess whether or not the taxpayer involved had been subject to any discriminatory treatment. It derived that, while generally it is the state of residence of the taxpayer which must take into account his personal and family circumstances for tax purposes, in that case this task was left to the source state, which had to take into account the personal and family circumstances of a non-resident taxpayer because it was not possible for the state of residence to take them into account, since the foreign source income was exempt in that state and the taxpayer did not have any other relevant income in its state of residence. A system of taxation in the state of the residence of the taxpayer (worldwide taxation) is deemed coherent not with the ability-to-pay principle as described by the Court of Justice, but rather with the principle of "capacità contributiva" as enshrined in many national constitutions: by resorting to a worldwide taxation system, the state of the residence takes into consideration the overall economic capacity of the taxpayer. Ability-to-pay has more to do with taxation at source: see where the income really is. The same reasoning applies to loss compensation and to the determination of which state must take into account the losses incurred by a taxpayer.

2. The difficult reconciliation between the (necessarily) different perspectives of European and international tax law.

In the previous chapter of the research, it has been highlighted that, in the field of international law, even though, in practice, states show a certain degree of restraint in allocating their taxing powers, it is impossible to assert the existence of a binding principle or rule of territoriality, being it as a "general principle of law recognised by civilised nations" or as embedded in an international customary rule. With the consequence that sovereign states are generally free, in absence of any more specific rule

[259] Kemmeren, E.C.C.M., *The internal market approach should prevail over the single country approach*, cited above.

(e.g. provisions of an international treaty) to exercise their taxing powers on foreign income as they see fit, being it theoretically possible and legitimate for states to enact legislation levying taxes even on income having its source in foreign territory and even in a dearth of connections with the taxing state. For the same reasons, general international law does not encompass any prohibition of international double taxation, exception being made for the case-by-case solutions adopted by states to counter the negative effects of double taxation on their businesses and enterprises, either unilaterally or through bilateral tax treaties[260].

From this perspective, the international tax law "scenario" - the quite non-technical term is used in lack of another appropriate "more juridical" word, since it would be quite improper to resort to terms such as "system" or "legal order" - shows unavoidable differences from the European Union legal order. The existence of no boundaries or limits to the countries' taxing powern, in fact, cannot be as easily accepted with regards to the European Union context, which is characterised by both general principles (e.g., the principle of non-discrimination, the fundamental freedom of movement of persons, goods, capital and services, the freedom of establishment, etc.) and specific provisions (directives and regulations, or even Treaty provisions concerning, for example, competition) that are aimed at ensuring, amongst other purposes, the proper functioning of the Internal Market.

Different systems, different logics, different paradigms correspond, therefore, to different aims and different values that are pursued and protected by the two different "orders" (even though, as highlighted in the previous chapter, speaking of international tax law as a "system" or an "order" is quite incorrect), providing answers to basically different questions. Which explains why it is so difficult to reconcile such diverging perspectives, based on different values and aims. The European Union legal order is based on the paramount importance of the Internal Market, which characterises such order with a "functional nature", whereas the system made up of the bilateral tax treaties signed by countries is characterised by a global absence of any systematic nature and by an inherently selective approach, with the only purpose to prevent or remedy international juridical double taxation.

The different nature of the interests at play and the above-mentioned "functional" nature of European Union law serve to explain, *inter alia*, the hierarchical supremacy of European Union law (either primary and secondary) over international (bilateral or

[260] Van de Vijver, A., *International double (non-) taxation: comparative guidance from European legal principles*, in EC Tax Review, 2015, 5, 240.

multilateral) conventions signed by Member States. Article 351 TFEU establishes a general primacy of European Union law, obliging Member States to eliminate all of their conventional provisions that are not compatible with the Treaty or secondary EU law[261].

At the international level, where each State is an independent subject in terms of international law, sovereignty is one of the main elements constituting the nature of the state itself[262]. With specific regard to tax law, the concept of sovereignty has undergone considerably deep changes, especially after the creation of the European Union. Sovereignty is no longer conceived as unlimited and indivisible, but, on the contrary, as a unity composed of a variety of competences, some of which (or, even better, their exercise) can be delegated to a supranational entity. This explains why the States were able to attribute to the European Union the exercise of some competences derived from their constitutions, amongst which the exercise of (some) competences in the field of tax law.

It has been observed that direct tax issues before the Court of Justice do not so much concern interpretation of tax law, since the Court is not competent to interpret national law or bilateral tax treaties[263], as they concern general European Union law and principles, such as free movement, market access, market equality, distortions of competition, subsidiarity, proportionality, non-discrimination and so on. The fact that the Court is competent to interpret EU law, but not competent to interpret national or bilateral tax law, makes the integration of direct taxation by way of judicial intervention considerably complex, especially if we consider the role played in cross-border taxation by the treaty network between Member States, which is largely based on the OECD Model Convention (and its Commentary)[264].

The Court has also acknowledged that Member States, in shaping the limits of their fiscal jurisdictions and allocating their taxing powers, may find inspiration in the

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[261] For an overview of the relationship between international tax law and European Union law, see Pires, M., *Le fonti del diritto comunitario e il diritto internazionale*, in Di Pietro, A. (ed.), *Per una costituzione fiscale europea*, Padua, 2008, 125.

[262] According to R. Monaco, the concept of State sovereignty corresponds to a character of superiority of the State itself with respect to the human society it governs and not to any superior position with respect to other States which are part of the international community (R. Monaco, *Limiti della sovranità dello Stato e organizzazione internazionale*, in *Studi di Diritto Costituzionale in memoria di Luigi Rossi*, Milan, 1952, 370).

[263] Even though, according to Wattel, in cases such as *Wielocks* (case C-80/94), *X & Y* (case C-436/00) and *Van der Grinten* (case C-58/01), the Court of Justice has undertaken such interpretation of bilateral tax treaties or even of national tax law, which, in the absence of harmonisation of direct tax law in the European Union, should be left to the exclusive competence of the national judges. See Wattel, P.J., *Red herrings in direct tax cases before the ECJ*, cites above, 83.

[264] Terra, B.J.M., Wattel, P.J., *European tax law*, Alphen aan del Rijn, 2012, 25.

consolidated international practice, e.g. in the practice resulting from the implementation of the OECD Model Double Taxation Convention (and of its Commentary)[265].

In particular, the *Gilly* case is remembered as one of the first cases in which the Court ventured into the interpretation of double taxation conventions, in order to verify whether the connecting factors employed by tax treaties for the allocation of taxing powers amongst Member States and the double taxation relief mechanisms are compatible with European Union law and, more specifically, with the freedom of movement of persons. First of all, the Judges confirmed that the definition of the criteria for the allocation of taxing powers falls within the competences of the Member States and that they are free to design their tax jurisdiction making reference to the consolidated practice stemming from the OECD Model Convention, since European Union law is generally indifferent as to the criteria used for such division of taxing powers, which, in absence of any European Union measure on the point, are covered by national sovereignty. In its analysis, the Court also specified that the purposes of a double taxation convention is merely to prevent the same income from being taxes twice and not to ensure that the tax to which a taxpayer residing in one of the contracting countries is subject is not higher than that which would be levied in a purely domestic circumstance. Which confirms the essentially different perspective from which international tax law and European Union law operate.

As it has been shown in the previous chapter, international tax law is largely based on the distinction between residents and non-residents, with the first ones being generally taxed on their worldwide income and the second ones being taxed only on their domestically-sourced income. Therefore, international tax law is mostly concerned with the attribution of tax base between countries and with the consequent allocation of taxing powers.

It follows that the international tax law perspective is substantially different than the "Internal Market perspective", interpreted as a single jurisdiction where no "foreign" tax base is supposed to exist and no difference between residents and non-residents should apply in the name of principles such as non-discrimination and freedom of movement. However, as long as no primary or secondary European Union law on tax jurisdiction exists, Member States have to define and allocate their fiscal jurisdiction

[265] Similar statements can be found, amongst others, in judgements such as *Gilly* (Court of Justice of the European Union, 12 May 1998, C-336/96, *Mr and Mrs Robert Gilly v. Directeur des services fiscaux du Bas-Rhin*), *Saint Gobain* (Court of Justice of the European Union, 21 September 1999, C-307/97, *Saint Gobain ZN*), *Van Hilten* (Court of Justice of the European Union, 23 February 2006, C-513/03, *Heirs of M.E.A. van Hilten - van der Heijden v. Inspecetur van de Belastingdienst te Heerlen*) and *N. v. Inspecteur* (Court of Justice of the European Union, 7 September 2006, C-470/04, *N. v. Inspecteur*).

themselves, especially protecting it against base erosion, profit shifting and, more in general, fiscal incoherence[266].

Therefore, one of the basic clashes between the international and the EU perspectives is that international tax law considers as fundamentally different a taxpayer or a source of income which stays within the same tax jurisdiction and a taxpayer or a source of income which leaves a taxing jurisdiction or which divides itself up over two jurisdictions, whereas, on the other hand, European Union law considers these positions as fundamentally comparable, since all fiscally relevant events occur within the same single Internal Market[267].

Another consequence of the different approach characterising international (tax) law and European Union (tax) law of this different approach can be found in the considerably different importance and relevance of the role played by the concept of "non-discrimination" in the fields of international tax law and European Union (tax) law. It should be noted, in fact, that in the context of European Union law the principle of non-discrimination, as a general principle enshrined in the Treaties establishing the conditions for the development of a functioning Internal Market amongst sovereign Member States, has received a very high degree of attention, constituting one of the fundamental grounds on which the Court of Justice has ruled in its "negative harmonisation" of tax law across EU territory[268], whereas, in the international tax practice, the principle is generally neglected, though often (vaguely) mentioned in the bilateral treaties concluded between states[269].

On the point, it has been argued that each of the fundamental freedoms enshrined

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[266] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 452.

[267] This statement is generally correct, as is demonstrated, for example, by the consistent application, on the part of the Court of Justice, of the so-called "always somewhere approach", according to which income is taxed somewhere in the Internal Market and expenses and losses are deductible somewhere in the Internal Market. However, some discrepancies in the Court's case law have shown: for example, the Court in the *Schumacker* judgement, as we will see, has stated that residents and non-residents are not in a comparable position as far as tax law is concerned and that, therefore, a different fiscal treatment between the two categories of taxpayers could be allowed. See, for a general approach to the topic of the interaction between European Union law and international tax law, Pistone, P., *Towards European international tax law*, in EC Tax Review, 2005, 1, 4; Kemmeren, E.C.C.M., *Double tax conventions on income and capital and the EU: past, present and future*, cited above, 157.

[268] Santiago, B., *Non-discrimination provisions at the intersection of EC and international tax law*, in European Taxation, 2009, 5, 249; Farmer, P., *EC law and direct taxation. Some thoughts on recent issues*, in EC Tax Journal, 1995, 1, 101; Wassermeyer, F., *Does the EC Treaty force the EU Member States to conclude a multilateral tax treaty?*, in Lang, M. (ed.), *Multilateral tax treaties. New developments in international tax law*, The Hague-London-Boston, 1997, 21; Wouters, J., *The principle of non-discrimination in European Community law*, in EC Tax Review, 1999, 2, 102; Hinnenkens, L., *The search for the framework conditions of the fundamental EC Treaty principles as applied by the European Court to Member States' direct taxation*, in EC Tax Review, 2002, 3, 115.

[269] This is so true that part of the legal doctrine has stated that the non-discrimination provision should not have any place in a double taxation convention, since these instruments have as their only purpose the allocation of taxing powers on a bilateral basis for the purposes of the prevention of double taxation and should not pursue "ethical" aims. Of this opinion is Santiago, B., *Non-discrimination provisions at the intersection of EC and international tax law*, cited above, 252. For an overview on the debate, see Gammie, M., *Prospects for company and shareholder taxation*, in Intertax, 2003, 8, 258; Avery Jones, J., *The non-discrimination article in tax treaties*, in European Taxation, 1991, 10, 345.

in the Treaties is implicitly based on the non-discrimination principle, since each of the Treaty freedoms entails the abolition of obstacles to the free movement of products and persons and the prohibition of any discrimination on grounds of origin or nationality, which makes the non-discrimination principle instrumental for the attainment of the purpose of a proper Internal Market[270].

This appears to be true particularly with regard to cross-border taxation, even though the current wording of the Treaty on the Functioning of the European Union prohibits discrimination based on nationality, thus not explicitly covering all possible measures discriminating on the grounds of different elements, such as, for example and for the purposes of the present research, residence. However, the Court of Justice has clarified that the Treaty non-discrimination principle must be interpreted as prohibiting all forms of discrimination based on nationality, even if covert or indirect, as a discrimination based on residence could amount to a disguised discrimination on the ground of nationality[271]. The point will be further developed in the following pages of this work, where cases such as *Schumacker* or *Gerritse* will be examined.

The differences described above between the European and the international perspectives also explain the significantly different meanings that the concept of "territoriality" has acquired in both context. It has been shown in the previous chapter of this study that, in the international field, the concept of "territoriality", in the impossibility of identifying a binding principle of territoriality for the reasons described earlier, is used as a criterion for the allocation of taxing powers amongst countries, i.e. for the distribution of tax bases and tax revenue amongst states in the hypothesis of cross-border transactions. In the European Union context and, in particular, in the Court of Justice's jurisprudence, as it will be shown, "territoriality" assumes an entirely different meaning, inherent to the different purpose and nature of the European Union, being interpreted and construed mainly as "the need to ensure a balanced allocation of taxing powers" amongst Member States. This point will be further developed in the following pages of the present research, where we will analyse more in detail the evolution of the Court of Justice's case law and its current approach to the topic.

2.1. Can European Union law succeed where international law (inevitably) failed, with a general prohibition of international double taxation?

[270] Gammie, M., *The compatibility of national tax principles with the single market*, in Vanistendael, F. (ed.), *EU freedoms and taxation*, Amsterdam, 2006, 106.

[271] It should be noted that the Commission has suggested the possibility to formally equate nationality and residence as far as non-discrimination in the field of taxation is concerned; see Commission Communication on *Company taxation in the Internal Market*, COM(2001)582.

As it has been shown, general international law does not encompass any (binding) principle imposing countries to enact measures to aim of preventing international juridical double taxation: states enter into bilateral (or sometimes multilateral) conventions in order to prevent double taxation in light of reasons of a merely political and practical nature, and not because they are bound to do so by virtue of any general principle or customary rule embedded in the international law legal order.

The conclusions must, or at least should, necessarily be (partially) different as far as the European Union context is concerned, also in light of what has been stated above concerning the prevalence of the Treaty purpose of the attainment of a properly functioning and fully integrated Internal Market, which is not easily reconciled with a territory where cross-border transactions are not relieved from the negative effects of double taxation.

Acknowledging the correctness of this assumption, the previous version of Article 293 of the EC Treaty provided that "*Member States shall, so far as it is necessary, enter into negotiations with each other with a view to securing, for the benefit of their nationals, […] the abolition of double taxation within the Community […]*". With the Treaty of Lisbon, the provision was repealed, with no explanation of its repeal being provided by any accompanying document. The absence of any justification has led to various explanations being suggested by several authors who have wondered about the reasons behind the adoption of such a measure[272].

Some have suggested that the repeal of Article 293 of the EC Treaty should be interpreted in the sense that prevention of double taxation is not considered as a goal of the European Union any more, which, however, would seem to be contrasting with the Court of Justice's case law and with the need to preserve the proper functioning of the Internal Market (and the free movement of persons, capital and services and the freedom of establishment). Other authors have interpreted the abolition of Article 293 of the EC Treaty in the exact opposite way, arguing that this measure should be interpreted as meaning that the prevention of double taxation is not a purpose which should be pursued by way of bilateral negotiations any more and that, therefore, the European

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[272] See, for example, Kemmeren, E.C.C.M., *After repeal of Article 293 EC Treaty under the Lisbon Treaty*, in EC Tax Review, 2008, 2, 145; Hinnekens, L., *The uneasy case and fate of Article 293 Second indent EC*, in Intertax, 2009, 37, 602; Reimer, E., *The abolition of Article 293 EC: comments on Hofmann's analysis*, in Rust, A. (ed.), *Double taxation within the European Union*, The Hague, 2011, 87; Sullivan, J., *The non-exercise of taxing powers by Member States and its compatibility with EC law*, in European Taxation, 2009, 4, 193; Nieminen, M., *Abolition of double taxation in the Treaty of Lisbon*, in Bulletin for International Taxation, 2010, 330; Cerioni, L., *Double taxation and the Internal Market: reflections on the ECJ's decisions in Block and Damseaux and the potential implications*, in Bulletin for International Taxation, 2009, 11, 543.

Union has acquired direct competence in the matter, even though without an obligation to actually use such a competence[273].

What can be considered as certain is that the mere fact that there is still a problem concerning double taxation from the EU law perspective is proof enough of the fact that, with regards to direct taxation, the European Union legal order operates in a context where Member States still enjoy a substantially "full" degree of sovereignty (exception being made for the provisions of secondary law on specific aspects of cross-border income). Whereas, in the international (tax) law context, the width of state sovereignty in direct taxation is limited by the interplay of bilateral double taxation conventions, when it comes to the European Union scenario such effect comes as the result of the need to comply with the fundamental Treaty freedoms, which justifies a (partial) transfer of sovereignty from the national to the supranational sphere even in the field of direct taxation.

That being said, there is still uncertainty in legal scholarship as to whether or not a general prohibition of double taxation should be included amongst the fundamental EU principles (together with e.g. non-discrimination, equality, loyal cooperation and so on)[274]. In fact, even though the prevention of double taxation is unanimously considered as a highly desirable purpose to be attained to the aim of creating a more perfect internal market, the existence of a general principle enshrining the prohibition of double taxation is the object of much doubt, also because of the lack of a coherent approach on the topic by the Court of Justice of the European Union[275].

The reference on this point should be to the "*Kerckhaert Morres* doctrine", which will be examined further in the development of the research. Suffice it to say now that, according to this approach of the Court of Justice, given that there are currently no EU-level provisions and rules concerning the harmonisation of direct taxes within the Internal Market, the prejudicial effects deriving on taxpayers and on their cross-border income simply from the implementation by Member States of their fiscal measures, provided that there are not *per se* discriminatory, cannot be remedied by invoking the protection deriving from the Treaty freedoms, since these negative results are nothing more than the result of the "parallel exercise" of taxing powers and tax jurisdictions on the part of the Member States.

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[273] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 15; *contra*, Marres, O., *The principle of territoriality and cross-border loss compensation*, in Intertax, 2011, 3, 116.

[274] For an analysis of the various meanings and implications of the concept of "double taxation" in the context of the European Union, see Traversa, E., *Il divieto di doppia imposizione*, in Di Pietro, A., Tassani, T. (eds.), *I principi europei del diritto tributario*, Padua, 2013, 328.

[275] Especially after the repeal of Article 293 of the EC Treaty by way of the Treaty of Lisbon.

This concerns especially international double taxation, in the European Union context. Double taxation, in fact, is generally the result of a non-coordinated, but inherently legitimate (and often not *per se* discriminatory) exercise of taxing powers by different authorities, each of which relies on different criteria (territorial, personal or material) in order to establish a link between the income and the state imposing the tax and to justify the tax itself, as it has been shown in the first chapter of the research. In other terms, double taxation derives from the overlapping of the tax bases from the points of view of two or more distinct, separate and independent legal orders: it is not, therefore, the result of a conflict of rules, but rather the result of the combined effect of different rules[276]. This is what the case law of the Court of Justice and the juridical literature formed on the point has defined as "disparity", which does not constitute, *per se*, a breach of European Union law. However, the jurisprudence of the Court of Justice on this point is far from being consistent and coherent, having sometimes disallowed such an approach, forcing Member States to modify the extension of their fiscal systems in order to avoid international double taxation.

Notwithstanding this latest observation, which we will develop further in the following pages, what should be recognised beyond any doubt is that, as has been noted by large part of the legal doctrine, the prevention of double taxation is, or should be, an at least implicit purpose of the European Union, since it can hardly be doubted that the overlap of taxing jurisdictions leads to distortions of the proper functioning of the Internal Market[277], and that "*double tax conventions and the EC Treaty are natural friends, because they pursue mutual objectives*"[278]. The Court of Justice has essentially reached, in principle, the same conclusions, recognising, for example, that "*conventions preventing double taxation such as those envisaged in Article 293 EC are designed to eliminate or mitigate the negative effects on the functioning of the Internal Market resulting from the coexistence of national tax systems*"[279].

Nonetheless, as it will be shown in the following pages of the research, the attitude of the Judges has not always proven to be in line with such a general principle. Also the Commission, on the other hand, has been considerably proactive in pointing

[276] Tarigo, P., *Gli elementi costitutivi della doppia imposizione internazionale quale fattispecie dei trattati*, in Rass. Trib., 2009, 3, 670.
[277] Lehner, M., *A significant omission in the Constitution of Europe*, in British Tax Review, 2005, 337.
[278] The expression is drawn from Kemmeren, E.C.C.M., *Principle of origin in tax conventions*, cited above, 246.
[279] Court of Justice of the European Union, 14 November 2006, C-513/04, *Kerckhaert Morres*. On the same point, see also, amongst others, Court of Justice of the European Union, 12 February 2009, C-67/08, *Block*; Court of Justice of the European Union, 6 December 2007, C-298/05, *Columbus Container Services*.

out the importance of eliminating double taxation within the Internal Market[280].

3. The "debut" of territoriality in the Court's case law: a tax system that is in line with the fiscal principle of territoriality cannot breach EU law.

The first explicit mention of the concept of "territoriality" in the words of the Court of Justice of the European Union may be found in the *Futura* judgement[281]. Briefly said, the case dealt with a French company with a permanent establishment (branch) in Luxembourg, which had asked for compensation of the losses suffered in France by the head office for the purpose of calculating the basis of assessment for the Luxembourg branch. One of the conditions provided for by Luxembourg tax law for the granting of such loss relief to non-resident subjects was that the losses had to be "economically linked" to an item of income generated in Luxembourg through the economic activity that was the source of the taxed income. The issue was, therefore, whether or not the requirement of an "economic link" could be permitted under European Union law.

The Court found such provisions - according to which, essentially, limited tax liability is applied to non-residents and unlimited tax liability is applied to residents[282] - to be in line with the fiscal principle of territoriality and, therefore, not able to give rise to any discrimination prohibited by EU law. More specifically, the Court held that the freedom of establishment does prevent a Member State from conditioning the carry-forward of losses incurred by a non-resident taxpayer on the fact "*that the losses must be economically related to the income earned by the taxpayer in that State, provided that resident taxpayers do not receive more favourable treatment*". It then ruled that the system at issue, "*which is in conformity with the fiscal principle of territoriality, cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty*"[283]: applying this approach, measures in line with the principle of territoriality might, therefore, be used by Member States to deny the deduction of foreign losses of persons subject to limited tax liability if foreign profits are not taxable in the source Member State, whereas persons subject to

[280] The Economic and Social Committee had even proposed to modify former Article 293 of the EC Treaty to the effect that "*double taxation or the absence of taxation is incompatible with the Internal Market*"; see Opinion of the Economic and Social Committee on Taxation in the European Union, 1997.
[281] Court of Justice of the European Union, 15 May 1997, C-250/95, *Futura Participations and Singer*.
[282] On the point, the Court's judgement started from the assumption that "*Luxembourg law provides that, as regards resident taxpayers, all of their income is taxable, the basis of assessment to tax not being limited to their Luxembourg activities. Consequently, although there are exemptions under which a part or event, in certain cases, all of their income earned outside Luxembourg is not subject to tax in that country, the basis for assessment for resident taxpayers at any rate includes profits and losses arising from their Luxembourg activities. On the other hand, for the purpose of calculating the basis for assessment for non-resident taxpayers, only profits and losses arising from their Luxembourg activities are taken into account in calculating the tax payable by them in the State*".
[283] Court of Justice of the European Union, 15 May 1997, C-250/95, *Futura Participations and Singer*, par. 22.

unlimited tax liability have the option to deduct foreign losses since they are generally taxed on their worldwide income.

At the outset, it should be noted that the Court assumes that the "principle of territoriality" is also applied to residents when they are taxed on their worldwide profits[284], which means that the Judges resort to a notion of "territoriality" as coinciding with the concept that, in the previous chapter of the research, has been defined as "territoriality as a principle", as opposed to the concept of "territoriality as a criterion", as a possible synonym of "limited taxation" or "taxation at source". In other words, the Court considers that a Member State acts in accordance with the principle of territoriality when it taxes resident taxpayers on their worldwide income and non-resident taxpayers on their income sourced in its territory[285]. A different interpretation of the concept of "territoriality" would seem to have been provided by the Luxembourg Judges in other subsequent judgements, e.g. *Kerckhaert Morres*, as it will be shown in the following pages, whereas a similar statement to that rendered in *Futura* may be found, for example, in the *Marks & Spencer* decision.

Moving on, the Court's reasoning amounted, essentially, to radically excluding that a tax system conforming with the principle of territoriality could be in contrast with the Treaty freedoms and, more in general, with European Union law: according to the Court of Justice, a tax system complying with territoriality (i.e. excluding foreign-source positive and negative elements from the domestic tax base) cannot be considered to amount to any discrimination prohibited by the Treaties[286]. In *Futura*, the Court has effectively relied on territoriality to justify its acceptance of a difference in treatment between residents and non-residents in the exercise of tax jurisdiction on the part of the Member State, together with the consequent distinction between worldwide taxation and taxation at source.

Some authors have also interpreted this statement in *Futura* as a reiteration of the concept of "fiscal cohesion" first introduced in the *Bachmann* judgement[287], confirming the compatibility with European Union law of tax systems providing for a consistent territorial matching, for tax purposes, of profits and corresponding losses[288].

After *Futura*, however, if we exclude some rare cases (such as the *Marks & Spencer*,

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[284] Weber, D., *Is the limitation of tax jurisdiction a restriction of the freedom of movement?*, cited above.
[285] Marres, O., *The principle of territoriality and cross-border loss compensation*, cited above, 113.
[286] Wattel, P.J., *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing powers. What is the difference?*, in Weber, D. (ed.), *The influence of European law on direct taxation. Recent and future developments*, The Hague, 2007, 139.
[287] Court of Justice of the European Union, 28 January 1992, C-204/90, *Bachmann v. Belgium*.
[288] In later judgements, such as *Verkooijen* (Court of Justice of the European Union, 6 June 2000, C-35/98), the Court of Justice described the argument based on the cohesion of the tax system as referred to the symmetry between "*the grant of a tax advantage and the offsetting of that advantage by a fiscal levy*".

Bosal Holding and *Manninen* judgements, and few others), the Court has not made explicit reference to the concept of "territoriality" anymore, resorting to different words that could probably (but it should not be taken for granted, as we will see) have the same meaning as "territoriality", such as "cohesion", "coherence" or "balanced allocation", thus creating a certain degree of confusion as to the actual relevance of territoriality in the allocation of taxing powers amongst Member States and in the evaluation of the compatibility of national tax provisions with EU law.

It is, in fact, difficult to see the difference between "fiscal territoriality" and "fiscal cohesion" in the words of the Court[289]. Both concepts refer to the need to treat tax base increases and connected tax base reductions in a symmetrical way within the same tax system, i.e. to protect the balanced allocation of taxing rights. The necessity to balance the allocation of taxing powers amongst Member States, as interpreted, for example, in *Marks & Spencer*, is supposed to be developed, according to the Court's reasoning, on the basis of the principle of territoriality as supposedly enshrined in international tax law. It follows that Member States may protect their fiscal jurisdictions against attempts to erode their tax bases by resorting to losses or expenses suffered in different countries. Using the words of AG Poiares Maduro, the concept of the need to preserve the balanced allocation of taxing powers, in the Court's case law, has a "corrective function", which is to ensure "*the protection of the integrity of the national tax systems within the context of the Internal Market*"[290], or, in other words, to restore the balance between the necessity to respect the Treaty freedoms and the Member States' tax sovereignty[291]. If this is what the need to preserve the allocation of taxing rights amongst Member States means, the justification would seem to be nothing more than a different definition or description of fiscal cohesion (and of the "fiscal principle of territoriality").

As we will see, an exception to the general rule stated in *Futura* may arise in case the "*Schumacker* doctrine" applies and almost all of the taxpayer's income is received in the source Member State and losses are considered to concern the "personal or family sphere" of the taxpayer (if the taxpayer is a physical person, an individual): in this case, non-residents, according to the Court's case law, should be granted the right to deduct foreign losses even though foreign profits are not taxable in the source Member State, otherwise such losses might end up not being taken into consideration neither in the residence state nor in the source state, thus leading to discrimination to the detriment of

[289] Wattel, P.J., *Red herrings in direct tax cases before the ECJ*, cited above, 92.
[290] Opinion of AG Poiares Maduro on case C-446/03, *Marks & Spencer*.
[291] De la Motte, A.M., *Tax sovereignty, national transfer of tax losses within international groups of companies and freedom of establishment*, in Common Market Law Review, 2015, 1079.

non-resident taxpayers.

At a later time, however, the Court dealt with territoriality in an entirely different manner. If, from the perspective adopted in *Futura*, compliance with the principle of territoriality excluded *ex se* the fact that a fiscal measure could breach EU law - thus not being necessary to evaluate the existence of possible justifications of such a breach, because no breach could be detected - in subsequent judgements, the analysis of the compatibility between a fiscal measure and the principle of territoriality shifts to the level of the possible justifications of such restrictive measure and the concept of territoriality begins to be associated with other terms, such as "coherence", or, more frequently, "balanced allocation of taxing powers". In other words, in the subsequent judgements of the Court of Justice, the compliance with the principle of territoriality is no longer considered as sufficient *per se* to exclude the existence of a breach of European Union law, but only as one of the possible reasons that could justify the legitimacy and tolerability of a breach of EU law on the part of a Member State.

4. Territoriality vs. ability-to-pay: the first clue of the Court's "interventionism" in the allocation of taxing powers amongst Member States.

In subsequent judgements, especially concerning individual taxpayers, the Court of Justice introduced a new element to its analysis on the compatibility of the national tax treatment of non-residents or, more in general, of cross-border transactions with European Union law. It is an element that had not been taken into consideration before, even though it is not mentioned in the Treaties, and that directly conflicts with the relevance of the principle of territoriality for the purposes of excluding that a certain tax measure could be breaching European Union law, limiting the possibility for Member States to invoke territoriality in order to avoid being found in breach of EU law with regards to measures imposing a different fiscal treatment of residents and non-residents: it is the concept of "ability to pay".

A "traditional" approach to the topic of the interaction between the principle of territoriality and the criteria for the allocation of the states' taxing powers would theoretically impose to disregard any relevance of "ability to pay", given the inherent difference between the two concepts. However, from a European Union perspective, the two perspectives are closely intertwined, since, as we will see, the Court of Justice has actually resorted more than once to the concept of "ability to pay" in its decisions concerning direct taxation.

The concept of "ability to pay" has always played a limited role in the field of international tax law and, in general, in the allocation of taxing rights amongst states in the international tax scenario[292]. By contrast, in the European Union context, the constitutional basis for the "ability to pay" principle varies considerably between Member States. While in some countries (such as Italy, Spain and France) the principle is expressly incorporated into the constitution, in other states (such as Germany) the same principle is considered as an indirect corollary of constitutional rules and in some other countries (e.g. the United Kingdom) the ability to pay principle is not formally incorporated in the constitution, but is anyway used as a guiding principle for the implementation of tax policies.

As far as the European Union legal order is concerned, since, as mentioned above, there is no legal basis, with the exception of custom duties and a few agricultural levies, providing the EU with any power to tax and since the EU as such has no direct competence with respect to the Member States' economic and fiscal policy, the Treaties do not contain any direct reference to ability to pay as a general guiding principle to which Member States must comply in exercising their taxing powers.

However, although the European Treaties do not make any explicit reference to the "ability to pay" concept, the Court of Justice of the European Union and the European Commission have consistently applied the fundamental freedoms in fiscal matters in a way that clearly reflects a particular attention to the concept of the ability to pay in the field of taxation of cross-border transaction in the context of the EU Internal Market. Notwithstanding the absence, in the European Treaties and in all pieces of EU primary law, of any explicit reference to the ability to pay, the case law of the Court of Justice of the European Union clearly shows that said concept has played a fundamental role in shaping the Court's jurisprudence on the evolution of the relevance of the principle of territoriality and on the difference in treatment between residents and non-residents for fiscal purposes.

It has also been argued that the Court of Justice itself has used the general non-discrimination clause enshrined in the Treaties in combination with the ability-to-pay principle in order to foster as far as possible the harmonisation of the direct tax systems across the European Union or at least in order to remove the barriers preventing such

[292] For an interesting short history of the evolution of the concept of "ability to pay" see Vanistendael, F., *The ability to pay principle in the EU legal order*, cited above 198. See also De Mooij, R.A., Stevens, L.G.M., *Exploring the future of ability to pay in Europe*, in EC Tax Review, 2005, 1, 9.

harmonisation[293]. In doing so, the Court had developed new principles of non-discrimination which differ from the usual non-discrimination rules enshrined in bilateral double taxation conventions. However, the application of such concepts has not been systematic and the ability-to-pay principle *per se* has not been used, so far, as a test to establish possible infringements of EU law on the part of the Member States[294].

It is important, however, to clarify, before proceeding in the analysis of the relevant case law on the point, that "ability to pay" as construed by the Court of Justice of the European Union does not exactly coincide with the equivalent concept that may be found in the Member States' own constitutional legal orders. Such a concept, from a purely national and domestic point of view, has essentially the purpose, briefly said, to ensure a fair and balanced distribution of the fiscal burden amongst the citizens, making sure that each citizen contributes to the public expenditure accordingly with its own economic capacity and possibilities.

Naturally, this cannot be the meaning of such a concept in the European Union context, given all that we have said before on the lack of any direct taxing power in the hand of the European Union itself and on the absence of any socio-economic purpose of an equitable redistribution of wealth in the "EU DNA". Therefore, the concept of "ability to pay" cannot but assume a partially different meaning in the words of the Court of Justice, even though this has never been expressly clarified by the Court. Essentially the "ability to pay" concept as applied by the Luxembourg Judges - and not by the EU legislature, to whom the concept itself remains, as of today, completely foreign - refers to the need to link direct taxation with the place where the income on which tax is levied lies, possibly even contradicting, to a certain extent, the distribution of taxing powers agreed upon by Member States, either by way of tax treaties or through unilateral measures.

The first EU judgement in which a point of ability to pay was raised by the Court with concern to the tax treatment of a non-resident was *Schumacker*[295], where the Luxembourg Judges for the first time accepted that a different tax treatment between residents and non-residents does not, in principle, constitute *per se* an infringement of EU law. In fact, besides being a paradigmatic case on the point of the application of principle

[293] Greggi, M., *Revisiting Schumacker: the role of limited tax liability in EU law*, in Richelle, I., Schon, W., Traversa, E. (eds.), *Allocating taxing powers within the European Union*, cited above, 46; Vanistendael, F., *The ability to pay principle in the EU legal order*, cited above, 211.
[294] This is probably partly due to the fact that, as highlighted by Vanistendael, the Treaties do not contain any direct reference to the ability-to-pay as a guiding principle for taxation, even though Articles 2 and 3 TEU refer to concepts such as justice, solidarity and equality which may be interpreted as implying the relevance of a principle such as ability-to-pay. See Vanistendael, F., *Ability to pay in European Community law*, in EC Tax Review, 2014, 3, 122.
[295] Court of Justice of the European Union, 14 February 1995, C-279/93, *Schumacker*.

of non-discrimination, and one of the most important and most quoted tax decisions of the Court of Justice of the European Union, the *Schumacker* judgement opened a new perspective on the "traditional" comparative analysis generally carried out by the Court, urging for an complex rethinking of the tax status of the non-resident taxpayer and limited tax liability and taking into account the overall result which followed from the application of the tax rules at issue in both the residence Member State and the Member State of source in order to assess whether or not discrimination ultimately arose. It is certainly safe to say that *Schumacker* is an example of the application, on the part of the Court, of the "overall approach": it could not be otherwise, considered the relevance played in this judgement by the concept of ability to pay.

As it is well known, the case dealt with the question whether or not a non-resident wage-earning taxpayer working abroad was entitled to the application of a particular income-splitting system with his spouse, which the source state, i.e. Germany, reserved only to its resident taxpayers[296].

The first part of the judgement is clear and simple. The Court begun its reasoning observing that it is supposedly easier to determine a taxpayer's personal and family circumstances for fiscal purposes in the state where the main part of his interests (personal and financial) lies and that "*accordingly, international tax law, and in particular the Model Double Taxation Convention of the OECD, recognises that in principle the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the state of residence*"[297].

The Judges then moved on to stating that the possible difference in treatment between residents and non-residents for tax purposes is not enough to find the tax provision at issue to be discriminatory and, therefore, to be in breach of the rights conferred on EU citizens by the Treaties and, in particular, of the fundamental freedoms. Especially because, according to the Court, "*in relation to direct taxes, the situations of residents and non-residents are not, as a rule, comparable*"[298]. This statement is in line with the

[296] And Article 24 of the OECD Model Convention, according to which the bilateral tax treaty relevant in the case at issue had been shaped, expressly excludes this kind of personal deductions from the scope of application of the non-discrimination principle.

[297] Court of Justice of the European Union, 14 February 1995, C-279/93, *Schumacker*, par. 32.

[298] Court of Justice of the European Union, 14 February 1995, C-279/93, *Schumacker*, par. 31. The Court has confirmed this statement in subsequent judgements as well. See, for example, more recently, Court of Justice of the European Union, 24 February 2015, C-512/13, *Sopora*; Court of Justice of the European Union, 24 February 2015, C-559/13, *Grunewald*; Court of Justice of the European Union, 18 June 2015, C-9/14, *Kieback*, where the Court has re-affirmed that "*in relation to direct taxation, residents and non-residents are generally not in comparable situations because the income received in the territory of a Member State by a non-resident is in most cases only a part of his total income, which is concentrated at his place of residence, and because a non-resident's personal ability to pay tax, determined by residence to his aggregate income and his personal and family circumstances, is easier to assess at the place where his personal and financial interests are centred, which in general is the place where he has his usual abode*". For a

fiscal principle/criterion of territoriality: recognising that residents and non-residents are not in comparable situations acknowledges and justifies that residents and non-residents may be subject to different treatments by countries as far as taxation is concerned, recognising that, for residents, tax is generally levied on a worldwide basis, whereas, for non-residents, tax is levied only on income produced within the territory of the country imposing such tax[299].

Going back to the reasoning of the *Schumacker* judgement, the Court specifies therein that in case the non-resident taxpayer were to derive most of his personal and family income from employment in the state of source, then the non-resident taxpayer could be considered as being in the same situation as a resident taxpayer, since the latter generally earns the major part of his income in the country where he resides[300]. This in the name of the general principle of equality and non-discrimination, since, according to the Court, "*the Community principle of equal treatment requires that, in the State of employment, the personal and family circumstances of a foreign non-resident be taken into account in the same way as those of resident nationals and that the same tax benefits should be granted to him*" and that "*discrimination arises from the fact that* [a taxpayer's] *personal and family circumstances are taken into account neither in the State of residence nor in the State of employment*" [301].

Even without ever expressly mentioning the concept, the Judges have clearly reached such a conclusion considering the overall ability to pay of the taxpayer involved, rather than a specific provision or tax regime, and used it as a parameter to elaborate a model of allocation of taxing powers (and consequent duties) amongst Member States. While in other cases the existence of a possible discrimination was assessed by taking into consideration the different treatments given to two categories of subjects (resident taxpayers on one hand and non-resident taxpayers on the other hand), in *Schumacker* the

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comment on the latter case, see Peeters, B., *Kieback: when Schumacker emigrates…*, in EC Tax Review, 2016, 2, 58. On a similar point, see also Court of Justice of the European Union, 12 December 2013, C-303/12, *Imfeld*.

[299] Wattel does not agree with the statement that residents and non-residents should be considered as generally not comparable; see Wattel, P.J., *Red herrings in direct tax cases before the ECJ*, cited above, 85.

[300] A similar principle had been formulated also by the Commission in its 1993 Recommendation "*on the taxation of certain items of income received by non-residents in a Member State other than that in which they are resident*" (Commission Recommendation 94/79/EC of 21 December 1993), concerning income from dependent personal services, pensions, income from professional occupations or other self-employed activities, income from agricultural and forestry activities and income from industrial and commercial activities. The 1993 Recommendation called upon Member States not to subject such items of income, "*in the Member State of taxation, to any heavier than if the taxpayer, his spouse and his children were resident in that Member State*", subject "*to the condition that the items of income […] which are taxable in the Member State in which the natural person is not resident constitute at least 75% of that person's total taxable income during the tax year*".

[301] Court of Justice of the European Union, 14 February 1995, C-279/93, *Schumacker*, par. 41. It has been argued that the concept of "discrimination" thereby affirmed would be "incomprehensible", since it would not be possible to define discrimination by reference to something another Member State is not doing and would also fail in designating which of the Member States is doing the discriminating. Authors have highlighted that this statement by the Court would ignore that, as the Court itself has consistently argued, the Treaties do not guarantee a change of jurisdiction to be fiscally neutral, nor require a Member State to adapt its tax rules to the other Member State's system such as to ensure fiscal neutrality of secondary establishments abroad. See Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 75.

Court considered the German rules to be in violation of the Treaty even if the taxpayer at issue was not resident in Germany, since he generated most of his income there[302].

Most commentators, right after the publication of the judgement at issue, have highlighted that, in formulating its decision, the Court was probably moved by the fact that excluding the non-resident taxpayer from the possibility of application of the income-splitting system would result in a situation where the personal circumstances of the taxpayer would not be taken into account anywhere in the Internal Market, neither in the state of residence nor in the source state[303].

It has also been correctly argued that, in *Schumacker*, a violation of the non-discrimination principle was found in the application to the non-resident taxpayer of the tax provisions of the source state and of the residence state taken together. In other terms, Germany was simultaneously treating the taxpayer concerned both as a resident taxpayer and as a non-resident one. What counted the most in the application of the tax regime at issue was not the residence of the individual *per se*, but rather the "residence of his ability to pay": in a certain sense, substance was prevailing over form[304], with the difference between "source rules" (limited tax liability) and "residence rules" (unlimited tax liability) blurring in case the major part of the taxpayer's income is located in the source state and not in its state of residence.

Scholars have highlighted that the *Schumacker* judgement was an extreme case of "all or nothing"[305]. One of the peculiarities of the *Schumacker* case can be found in the fact that Mr. Schumacker's liability, which was supposed to be a limited tax liability, being him a non-resident subject, was a *de facto* full liability to tax, since he produced practically all of his income in the source state.

[302] This statement has been criticised by part of the legal scholarship. Wattel, for example, has argued that, in his opinion, the percentage of income earned in the Member State of source would not be a reliable criterion for altering the allocation of the taxing powers amongst Member States, also because, in order to reach a correct implementation of such an allocation, the "job country" would need to know the total income and the personal circumstances of the non-resident worker, which might prove difficult. See Wattel, P.J., *Red herrings in direct tax cases before the ECJ*, cited above, 85 ("*it remains unclear what justification the percentage division of the total income between the two States would offer for the discrimination against non-residents*").

[303] More in detail, the Court has rejected the source state's (Germany's) argument for not taking into account the personal situation of the non-resident taxpayer, which was that, in that case, the personal situation of the taxpayer would be taken into account twice, that is to say once in the source state and once in the state of residence, leading to undue tax savings on the part of the taxpayer. On the contrary, the Court of Justice stated that such an argument could not be upheld because "*in a situation such as that in the main proceedings, the State of residence cannot take account of the taxpayer's personal and family circumstances because the tax payable there is insufficient to enable it to do so*" (Court of Justice of the European Union, 14 February 1995, C-279/93, *Schumacker*, par. 41).

[304] Greggi, M., *Revisiting Schumacker: the role of limited tax liability in EU law*, cited above, 46.

[305] The words are of Frans Vanistendael's (Vanistendael, F., *The ability to pay principle in the EU legal order*, cited above, 212).

Personal taxation entails the need to take into consideration the overall situation of the taxpayer[306]. This is done through personal allowances, credits or deductions, which are generally attributed in the state where the individual is resident. On the other hand, traditionally the source state does not allow any deduction related to family burdens or to other personal circumstances and expenditures. This system follows a sort of territoriality principle. In *Schumacker* the Court seems to push the "genuine link" theory to extremes, forcing a State to recognise tax advantages wherever it imposes a tax liability over a non-resident subject.

Following the above-mentioned reasoning, the Court seems to go beyond the traditional approach to source and residence and the general "presumption" that the state of residence is the one where the majority of a taxpayer's income lies. Given the apparent ground-breaking importance and novelty of such a statement, many thought at the time that the *Schumacker* judgement called for a rethinking of the approach to the traditional distinction between full and limited tax liability, thus expecting a sort of "revolution" of the Court's reasoning in tax cases and also an intervention from the EU legislature towards a higher level of harmonisation in direct tax matters.

Many scholars see the *Schumacker* decision as providing a legacy that is still to be appropriately dealt with by academics, judges and lawmakers and consisting in the need to rethink the concept of limited liability to tax and the rules on taxation at source, at least at the EU level[307]. However, the Court seems to have confirmed the principles enucleated in *Schumacker* in its subsequent decisions on the *Wielocks*[308], *Gshwind*[309], *Zurstrassen*[310] and *Wallentin*[311] cases, where the Luxembourg Judges essentially confirmed that the non-resident taxpayer is entitled to have all the aspects of his/her subjective ability to pay taken into account in the source Member State in case there is no tax liability in his/her Member State of residence.

In particular, in its *Lakebrink* judgement[312], the Court stated that the scope of the "*Schumacker* doctrine" extends to all the tax advantages connected with the non-resident's ability to pay tax which are granted neither in the Member State of residence

[306] Especially since personal taxes traditionally are the ones with whom social goals are pursued, such as redistribution of wealth. However, it has been observed that the *Schumacker* decision has left some technical questions unanswered, especially if we consider the position of a taxpayer earning his entire income abroad, but not in one, but two Member States different than the one where he resides. In this case, according to the "*Schumacker* doctrine", in neither of the source Member States involved he would receive "*his entire income*", meaning that his personal circumstances would be legitimately taken into account nowhere. On the point, see Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 525.

[307] Greggi, M., *Revisiting Schumacker: the role of limited tax liability in EU law*, cited above, 60.

[308] Court of Justice of the European Union, 11 August 1995, C-80/94, *Wielocks*.

[309] Court of Justice of the European Union, 14 September 1999, C-391/97, *Gschwind*.

[310] Court of Justice of the European Union, 15 May 2000, C-87/99, *Zurstrassen*.

[311] Court of Justice of the European Union, 1 July 2004, C-169/03, *Wallentin*.

[312] Court of Justice of the European Union, 18 July 2007, C-182/06, *Lakebrink*.

nor in the Member State of employment. In the *Lakebrink* decision, the Court held that, "*since the ability to pay tax may indeed be regarded as forming part of the personal situation of the non-resident within the meaning of the judgement of Schumacker*", the tax advantages "*connected with the non-resident's ability to pay tax which are not taken into account either in the State of residence or in the State of employment*" should be taken into account "somewhere" in the Internal Market. The same reasoning has been confirmed in the *Renneberg* judgement[313] as well, where the Court stated that, if the largest part of the income produced by the non-resident taxpayer is generated within the Member State of source, said Member State must grant the non-resident taxpayer the possibility to enjoy the same tax treatment reserved to residents, assessing the non-resident taxpayer's income on a worldwide basis.

The "*Schumacker* doctrine" was further developed and better specified in subsequent judgements, which have also recently clarified that "*in relation to tax advantages connected with a particular taxpayer's ability to pay tax, the mere fact that a non-resident has received, in the State of employment, income in the same circumstances as a resident of that State does not suffice to make his situation objectively comparable to that of a resident. It is additionally necessary, in order to establish that such situations are objectively comparable, that, due to that non-resident's receiving the major part of his income in the Member State of employment, the Member State of residence is not in a position to grant him the advantages which follow from taking into account his aggregate income and his personal and family circumstances*"[314]. This statement cannot but sound quite similar to the traditional implications of the Court of Justice's so-called "always somewhere approach", which we will analyse in the following pages with specific reference to the *Marks & Spencer* decision[315].

Notwithstanding the specification described above, the "*Schumacker* doctrine" evidently amounted to an actual disruption, on the part of the Court of Justice, of the need to protect the territorial allocation of taxing powers agreed upon by Member States, with a considerably "heavy" intervention in the allocation of taxing powers designed by Member States.

It has also been observed that the *Schumacker* decision did not provide an useful tool for solving cases in which the situation is not "so black or white", i.e. cases in which the personal deductions could only be partially taken into account in the state of

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[313] Court of Justice of the European Union, 16 October 2008, C-527/06, *Renneberg*.
[314] Court of Justice of the European Union, 18 June 2015, C-9/14, *Kieback*.
[315] Reference is made, specifically, to the "final losses criterion" as developed for the first time in the *Marks & Spencer* judgement and by virtue of which a Member State must allow the deduction of losses originated in another Member State if they cannot be used in that Member State.

residence, resulting in a higher tax burden for the employee exercising his freedom of cross-border movement. In such cases, in fact, since personal deductions can actually be - wholly or partially - taken into account by the state of residence, the source state is allowed, according to the Court of Justice, to tax the non-resident employee without necessarily taking into account any personal deduction[316]. The result is often that the total amount of tax due in the source state by the non-resident subject exceeds the amount of tax due in the state of residence by the same taxpayer, with the consequence that the higher tax burden suffered in the source state cannot be entirely taken into account by way of a tax credit in the state of residence.

This exact fact pattern was examined by the Court in the *Gilly* case[317], where the Court stated that, since no harmonisation measures for the elimination of double taxation has been adopted at EU level, Member States are competent to determine the criteria for income taxation with a view to eliminating double taxation by way of international agreements and that, therefore, a simple difference in treatment between residents and non-residents cannot be regarded, *per se*, as discrimination prohibited by the Treaties (even if a Member State chooses to shape its tax jurisdiction on the ground of nationality): whether or not the tax treatment of a certain taxpayer is favourable is not determined by the choice of the connecting factor, but rather by the level of taxation in the competent Member State.

In that case, the Court observed that any unfavourable consequence entailed by the tax credit mechanism at issue was nothing more than the result of the differences between the tax rates applied by the Member States concerned and that, in absence of any European Union legislation on the point, the Member States are free to determine these rates. According to the Court, any different answer would "*such as to encroach on the sovereignty*" of the Member State at issue in matters of direct taxation, with a consequent erosion of the principle of territoriality, since said Member State would not be able to tax the income having its source within its territory.

Subsequently, in the *Saint-Gobain* judgement[318], the Court confirmed that Member States are free to choose the connecting factors they deem most appropriate for the allocation of their fiscal jurisdiction, also by way of bilateral tax treaties, but that such allocation is subject to the examination of the Court of Justice of the European Union through the lens of the fundamental freedoms, even if the allocation so designed is based

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[316] Vanistendael, F., *The ability to pay principle in the EU legal order*, cited above, 212.
[317] Court of Justice of the European Union, 12 May 1998, C-336/96, *Mr and Mrs Robert Gilly v. Directeur des services fiscaux du Bas-Rhin*. For an overview of the most critical points of the judgement, see Avery Jones, J., *What is the difference between Schumacker and Gilly?*, in European Taxation, 1999, 1, 2.
[318] Court of Justice of the European Union, 21 September 1999, C-307/97, *Saint Gobain ZN*.

on a double taxation convention concluded with a third country[319]. In the *Saint-Gobain* decision, although the core problem of the case was the entitlement of a permanent establishment to treaty benefits, the Court of Justice basically stated that Member States are free, within the framework of bilateral agreements concluded to prevent double taxation, to determine the connecting factors for the purposes of allocating taxing powers amongst themselves, even though "*as far as the exercise of the power of taxation so allocates is concerned, the Member States […] may not disregard Community rules*".

It seem obvious that the "ability-to-pay perspective" and the "territoriality perspective" are not easily reconciled: for the taxpayer, his ability to pay is determined by the combination of the elements which are relevant for all the tax systems of the Member States where his income originates. The question is whether the Court of Justice should decide to make a proportional application of the "national concepts" of ability to pay depending on the proportion of the income that falls within the tax jurisdiction of each Member State[320] or whether this decision should be taken by the European Union legislature.

4.1. On the comparability of residents and non-residents.

One of the reasons why the *Schumacker* judgement is so often recalled and quoted is related to the statement according to which, in the Court of Justice's view, resident and non-resident taxpayers are not generally in comparable situations as far as direct taxation is concerned.

Acknowledging this general uncomparableness of the two categories of subjects essentially amounts to a recognition, on the part of Court, of the Member States' freedom in tracing the borders of their fiscal jurisdiction and taxing power and, in other words, the legitimacy of a tax system based on what the Luxembourh Judges called "principle of territoriality" in the *Futura* judgement, i.e. a tax system which treats residents and non-residents in different ways, starting from the recognition of the substantial difference of their positions. In fact, if residents and non-residents are not comparable, this means that a national tax measure cannot be considered as discriminatory, and in breach of EU law, in case it treats them in a different manner, given that, in the traditional "rule of reason" test of the Court of Justice, excluding comparability between two situations or two

[319] Non-tax case law of the Court of Justice shows that, under European Union law, benefits negotiated by Member States for nationals in treaties concluded between such Member States and third countries should also be extended to nationals of other Member States in identical or comparable circumstances. See, for example, Court of Justice of the European, 15 January 2002, C-55/00, *Gottardo*.

[320] Which is the solution advocated by Vanistendael, F., *Ability to pay in European Community law*, cited above, 134.

subject amounts to also excluding the possibility of a national measure breaching one of the fundamental freedoms or the general principle of non-discrimination.

Actually, the above-mentioned statement of the Court, according to which residents and non-residents are not generally in comparable situation, even though it has never been expressly denied or refuted by the Court of Justice in any of its subsequent judgements, constitutes nothing more than a general principle, or a general criterion, that has been made the object of so many exceptions and derogations in the subsequent jurisprudence that it has risked losing any effective interpretive and practical value.

The *Schumacker* judgement constitutes an example: residents and non-residents are deemed as not generally comparable, which would have led to the exclusion of the presence of a breach of European Union law, but, in the case at issue, the two situations were actually similar, and therefore comparable, in light of the simple, and contingent, fact that the non-resident taxpayer earned almost all of his income in the Member State of source, which made his situation, according to the Court, comparable to the situation of a person residing in that Member State.

On the point of the comparability of residents and non-residents, it should be noted, therefore, that, even after *Schumacker*, the Court of Justice has always accepted several exceptions to the general incomparableness of the two categories in other decisions as well, e.g. in the *Denkavit* case[321], where, as regards outbound dividends, it stated that "*resident shareholders receiving dividends are not necessarily in a situation which is comparable to that of shareholders receiving dividends who are resident in another Member State […]. However, as soon as a Member State, either unilaterally or by way of a convention, imposes a charge to tax on the income, not only of resident shareholders, but also of non-resident shareholders, from dividends which they receive from a resident company, the situation of those non-resident shareholders becomes comparable to that of resident shareholders*".

In the Court's judgement on the *Gerritse* case, the limitations to the deductibility of expenditure connected to services rendered by a non-resident provided for by German law show various similarities to the provisions examined in *Futura*, since they entailed the specific need for a "direct link" between the expenditure and the income accrued within the same Member State's jurisdiction, in conformity to the principle of territoriality as described (or, better, intended) in *Futura*. Once again, however, the Court denied the compatibility of such a measure with EU law in light of the need to grant equal treatment between a cross-border scenario and a purely domestic scenario and between residents and non-residents in order to ensure a correct implementation of a

[321] Court of Justice of the European Union, 14 December 2006, C-170/05, *Denkavit International and Denkavit France*.

progressive tax system, thus disregarding the principle of territoriality.

Briefly said, the case dealt with the questions of whether non-resident artistes performing in Germany and on which tax was levied by Germany through withholding taxes could claim deduction of expenses connected to their performance and of whether a flat withholding tax on gross income constituted an infringement of the fundamental freedoms. The Court started with the standard observation that situations of residents and non-residents are not comparable, as a rule, and that, therefore, a different treatment of the two categories is not necessarily always discriminatory[322].

The Judges then raised the question of whether the objective difference in the situation between residents and non-residents allows a Member State to disregard the discriminatory character of a flat rate at source without any tax-free allowance imposed on non-residents. On the point, the Court ruled that "*concerning the tax-free allowance, since […] it has a social purpose allowing the taxpayer to be granted an essential minimum exempt from all income tax, it is legitimate to reserve the grant of that advantage to persons, which have received the greater part of their taxable income in the State of taxation, that is to say, as a general rule, residents*".

Then the Court, partially stepping away from its "*Schumacker* doctrine", while testing the relevant German rules against the freedom of movement of services, stated that, as the business expenses in question were directly linked to the activity that generated the taxable income in Germany, residents and non-residents were placed in a comparable position in that respect, "*so that application to the former of a higher rate of income tax than that applicable to the latter […] would constitute indirect discrimination prohibited by Community law*". This statement was made by the Court without analysing the fact that the plaintiff had only earned a small percentage of his worldwide income in Germany[323].

The same could be said with concern to the *Conijn* judgement[324], which dealt with the question of whether non-resident participants in a German commercial partnership were allowed to deduct from their German tax base costs incurred to receive tax advice by professional advisors. In this case, even though the non-resident taxpayer at issue had earned a small percentage of his overall income in Germany, the Luxembourg Judges that, since the relevant costs were incurred by the plaintiff in preparing its tax return in respect of income derived in Germany and since it was the fact that he received that

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[322] Vanistendael, F., *Ability to pay in European Community law*, cited above, 127.
[323] Cordewener, A, *Personal income taxation of non-residents and the increasing impact of the EC Treaty freedoms*, in Weber, D. (ed.), *The influence of European law on direct taxation. Recent and future developments*, The Hague, 2007, 41.
[324] Court of Justice of the European Union, 6 July 2006, C-346/04, *Conijn*.

income which triggered his duty to file a tax return in Germany and, therefore, to receive fiscal advice, the costs at issue were directly linked to the income taxed in Germany. Furthermore, the Court even stated that both residents and non-residents are placed in a comparable situation as regards the complexity of national tax law. Once again, the Court chose not to apply the "*Schumacker* doctrine".

The topics of territoriality, of its relation with the requirement of a balanced allocation of taxing powers amongst Member States, of the treatment of residents and non-residents for tax purposes and of the general uncomparableness of the two categories of taxpayers were also addressed by the Court of Justice in its *Rewe* decision[325]. After having confirmed that a difference in treatment amongst resident parent companies depending on the place of establishment of their subsidiaries cannot be justified as a consequence of the mere fact that they have decided to carry on economic activities in another Member State, with an express denial of the above-mentioned general statement concerning the uncomparableness of residents and non-residents for tax purposes, the Court came to an analysis of fiscal territoriality and its relevance in the examination of the compatibility of domestic tax measures with European Union law.

The Court recalls that it can be accepted from an European Union law perspective that, in accordance with the principle of territoriality, the Member State of establishment of a parent company taxes companies residing in its territory on their worldwide income and non-resident subsidiaries only on the profits deriving from their activities conducted within its territory. However, according to the Court, such a principle cannot in itself justify the refusal by the Member State of residence of the parent company of an advantage on the ground that the same Member State does not levy tax on the profits of its non-resident subsidiaries. In doing so, the Court defined the purpose of the principle of territoriality as "*to establish in the application of EU law the need to take into account the limits of the Member States' power of taxation*"[326].

More recently, in its decision on the *Miljoen* case[327], the Court ruled that "*in relation to expenses such as business expenses which are directly linked to an activity that has generated taxable income in a Member State, that residents and non-residents of that State are in a*

[325] Court of Justice of the European Union, 29 March 2007, C-347/04, *Rewe Zentralfinanz*. For a comment on the judgement, see, amongst others, Kiekebeld, B.J., Smit, D.S., *EU free movement of capital and corporate income taxation: the relationship between the free movement of capital and the other TFEU freedoms and justification grounds in a third country context*, in Jansen, S.J.J.M. (ed.), *Fiscal sovereignty of the Member States in an Internal Market*, Amsterdam, 2011, 132.
[326] An identical definition has been given by the Court in its judgement on the *Busley* case (Court of Justice of the European Union, 15 October 2009, C-35/08, *Busley*).
[327] Court of Justice of the European Union, 17 September 2015, joined cases C-10/14, C-14/14, C-17/14, *J.B.G.T. Miljoen*, *X* and *Société Générale SA*. A similar statement can be found also in Court of Justice of the European Union, 31 March 2011, C-450/09, *Schröder*.

comparable situation, with the result that legislation of that State which denies non-residents, in matters of taxation, the right to deduct such expenses, while, on the other hand, allowing residents to do so, risks operating mainly to the detriment of nationals of other Member States and therefore constitutes indirect discrimination on grounds of nationality", especially since "*as soon as a Member State, either unilaterally or by way of a convention, imposes a charge to tax on the income, not only of resident taxpayers, but also of non-resident taxpayers, from dividends which they receive from a resident company, the situation of those non-resident taxpayers becomes comparable to that of the resident taxpayers*".

In light of all of the above, it has been stated that the "*Schumacker* principle" according to which the situations of residents and of non-residents are not, as a rule, comparable has been, at least partially, abandoned or even tacitly reversed by later judgements of the Court. Its implementation, first of all, is generally limited to individuals and does not extend to corporations or other juridical persons. It seems obvious, in fact, to state that legal persons do not have a subjective sphere comparable to the personal or family circumstances of human beings. It is also true that the Court, since its *Avoir fiscal* judgement, has always rejected the idea of a general incomparableness between a non-resident corporation and a resident corporation[328]. Moreover, even with regards to physical persons, the remaining field of application of the doctrine is their "subjective sphere", meaning tax rules related to the taxpayer's personal and family circumstances and their consequences on rights of deduction, which is the area where, until now, the Court seems to have strictly adhered to the idea of a general incomparableness between residents and non-residents[329].

This was not the case only for individuals, but also for corporations.

In the *Royal Bank of Scotland* case[330], the national measure at issue distinguished between companies having their seat in the Member State concerned (Greece) and companies having their seat in another Member State, but carrying on business in the first Member State through a permanent establishment, consequently allowing the former company to benefit from a lower tax rate which was denied to the second company.

In its judgement, the Court recognised the effect of the limited fiscal jurisdiction of the source Member State, but, however, stated very clearly that this circumstance, which "*arises from the limited fiscal sovereignty of the source State, is not such as to prevent the*

[328] Similar principles can be derived also from cases such as *Commission v. France* (28 January 1986, C-270/83), *Commerzbank* (13 July 1993, C-330/91) and *Metallgesellschaft* (8 March 2001, joined cases C-397/98 and C-410/98).
[329] Cordewener, A, *Personal income taxation of non-residents and the increasing impact of the EC Treaty freedoms*, cited above, 57, 59.
[330] Court of Justice of the European Union, 29 April 1999, C-311/97, *Royal Bank of Scotland plc v. Greece*.

two categories of companies [i.e. resident companies and non-resident companies] *from being considered, all other things being equal, as being in a comparable situation as regards the method of determining the taxable base*", since, in this case, resident banks and permanent establishments of foreign companies were subject to the same method of determination of their tax bases. In other words, according to this decision, equal treatment should be guaranteed within the boundaries of the source Member State's limited fiscal jurisdiction: the host Member State should, therefore, provide equal treatment to taxpayers insofar as their activities are within its jurisdiction as determined by national law and bilateral tax treaties, being such taxpayers in comparable situations for th purposes of the discrimination analysis[331].

The Court also held that the fact that companies having their seat in the Member State concerned are taxed on their worldwide income and foreign companies conducting business in that Member State through a permanent establishment only on the profits attributable to that permanent establishment does not amount to a difference in treatment possibly entailing a breach of European Union law, since the different treatment results from the principle of territoriality or, in the Court's words, "*from the limited fiscal sovereignty of the State in which the income arises*".

In other words, according to the Court, equal treatment should be guaranteed by Member State within the boundaries of the source Member State's limited fiscal jurisdiction, which means that the host Member State should treat taxpayers equally insofar as their activities are located within its jurisdiction as determined by tax treaties. This essentially amounts to the acknowledgement that the taxpayers concerned would find themselves in comparable situations for purposes of the analysis on the point of discrimination, which concerns not only domestic rules that distinguish between residents and non-residents, but also rules enshrined in a double taxation convention[332].

5. Territoriality as "balanced allocation of taxing powers amongst Member States" and the "always somewhere approach": after the "ability-to-pay principle", another step towards a homogeneous theory for the allocation of taxing powers amongst Member States?

Territoriality receives a significantly different treatment in subsequent

[331] More specifically, the Court found "*that companies having their seat in Greece are taxed there on the basis of their worldwide income (unlimited tax liability), whereas foreign companies carrying on business in that State through a permanent establishment are subject to tax there only on the basis of profits which the permanent establishment earns there (limited tax liability)*".

[332] Douma, S., *The three Ds of direct tax jurisdiction: disparity, discrimination and double taxation*, cited above, 527.

judgements of the Court of Justice, which considerably change the paradigm of general uncomparableness of residents and non-residents described above. This is particularly true with specific regard to the strain of the Court's case law concerning taxes imposed on transnational groups of companies and cross-border loss relief.

In cases such as *Bosal Holding*[333] and *Marks & Spencer*, for example, the analysis of the relevant domestic fiscal provisions has led the Court of Justice to results which have been considered as exactly opposite as to those which should have been reached if the principles stated in the *Futura* judgement had been strictly applied. Which essentially amounts to stating that the Court has changed its initial interpretation of what "territoriality" actually means for EU law purposes, with the analysis through the "territoriality lens" shifting from the first step of the "rule of reason test" (i.e. the existence of a discrimination caused by a national tax provision, which had been excluded when a tax system complied with the "international principle of territoriality", also by virtue of the general uncomparableness of resident and non-resident taxpayers) to the second level of said test, i.e. the analysis of a measure which has been considered as *per se* discriminatory/restrictive in order to understand whether or not such a measure can be justified by overriding reasons in the public interest.

In its *Marks & Spencer* decision[334], the Court of Justice, in confirming its traditional standing on the prohibition of discriminations and restrictions of outbound movements, clarified that the fact that a non-resident company is not subject to a Member State's tax jurisdiction does not allow said Member State to differentiate this situation from that of a resident company which is subject to tax therein, thus applying what has been defined as its "overall approach" and a completely different view on territoriality. One of the elements of novelty characterising this decision, if compared with previous judgements of the Court, lies in the analysis of the possible grounds for justification of discriminatory or restrictive measures.

In the *Marks & Spencer* judgement, in fact, the Court rejected the argument based only on territoriality according to which the distinction between residents and non-residents could justify *per se* a difference in treatment between the two categories of taxpayers. The Luxembourg Judges basically stated that the answer to the question needed to be based on the evaluation of each specific situation, then accepted the United Kingdom's argument that symmetry in the treatment of positive elements and negative elements of income (profits and losses) would be necessary to preserve the balanced

[333] On which we will further develop the analysis in the following chapter of the research.
[334] Court of Justice of the European Union, 13 December 2005, C-446/03, *Marks & Spencer*.

allocation of the taxing powers amongst Member States.

The Court is aware that *"by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State"*, the Member State of residence of the parent company acted *"in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law"*, but nonetheless added that, *"however, the fact that id does not tax the profits of the non-resident subsidiaries of a parent company established on its territory does not in itself justify restricting group relief to losses incurred by resident companies"*[335].

In its decision, the Court implicitly stated that, in certain cases, territoriality is not enough not only to exclude the existence of a breach of EU law, but also as a valid justification for said breach, being it necessary, on the contrary, to combine territoriality with other two justifications, i.e. the need to counter tax avoidance and the need to prevent any possible double use of the losses (double dip)[336]. According to the Court, in other words, the fact that the United Kingdom does not tax the profits of the non-resident subsidiaries of a parent company located in its territory, thus applying the fiscal principle of territoriality in a consistent manner, cannot *per se* justify a measure restricting group relief only to losses incurred by resident companies, because otherwise this would essentially amount to stating that the fact that subsidiaries are located in a different Member State from the Member State of residence of their parent company justifies a restrictive treatment[337].

Therefore, Member States are generally allowed to limit their tax jurisdiction to income having its source within their territory, following that, if a Member State does not levy tax on the positive income of foreign subsidiaries, then that State should also be allowed not to take into account the negative components linked to that foreign income. However, with regards to "final losses", the Court deviates from this general rule and follows what has been called an "always somewhere approach", which is the

[335] A similar statement can be found, for example, in the *Rewe* judgement, where the Court has states that the principle of territoriality *"does not in itself justify the Member State of establishment of the parent company refusing to grant an advantage to that company on the ground that it does not tax the profits of its non-resident subsidiaries"* (Court of Justice of the European Union, 23 February 2006, C-471/04, *Rewe*). In his Opinion on the case, AG Poiares Maduro argued that, should the definition of "balanced allocation" be based only on a *"rule of symmetry"* between the right to tax a company's profits and the duty of a Member State to take that company's losses into consideration, that definition would not significantly differ from a purely economic reasoning related to a reduction in tax revenue suffered by the Member States, which does not, in principle, qualify as a justification ground.

[336] AG Poiares Maduro has given his interpretation of such a statement in his Opinion on the *Rewe* case (AG Poiares Maduro's Opinion, 31 May 2006, C-347/04), suggesting that the criterion of a balanced allocation of taxing powers amongst Member State cannot stand alone as a justification, not being it possible to separate it from the other two criteria, i.e. the risck of "double dip" and the risk of tax avoidance. On the point, see Lang, M., *Direct taxation: is the ECJ heading in a new direction?*, in European Taxation, 2006, 9, 426.

[337] Isenbaert, M., *EC law and the sovereignty of the Member States in direct taxation*, Amsterdam, 2010, 715; Wathelet, M., *Tax sovereignty of the Member States and the European Court of Justice: new trends or confirmation?*, in Hinnekens, L., Hinnekens, P. (eds.), *A vision of taxes within and outside European borders*, Amsterdam, 2008, 912.

consequence of a sort of "tempered territoriality"[338]: if the losses of the foreign subsidiary cannot be deducted in the Member State where that subsidiary is established, then the Member State where the parent company is located must take them into account.

In doing so, the Court has, in other terms, established a sort of "order of priority", deciding that, in the event it were possible to deduct the losses at issue in both the Member State of residence of establishment of the subsidiary and in the Member State of residence of the parent company, it would have been necessary, for the purposes of protecting a balanced allocation of taxing powers amongst Member States, to give priority to the deduction of those losses in the Member State of establishment of the subsidiary concerned[339].

As it has been correctly observed, this reasoning leads to an asymmetrical treatment of non-resident subsidiaries, compelling Member States to take into account negative elements of income related to positive elements of income over which Member States do not have any fiscal jurisdictions, but only "in extreme circumstances", i.e. in so far as these negative elements cannot be taken into account anywhere in the Internal Market. Therefore, if, on one hand, it can actually argued that this solution somehow favours companies located in the European Union with cross-border activities (thus favouring, to a certain extent, the functioning of a proper Single Market), it certainly does not help to achieve a design a general system of profit allocation amongst Member States, since it conditions the extension of a Member State's tax jurisdiction upon circumstances which have to be analysed on a case-by-case basis: the United Kingdom was basically forced to extend its taxing jurisdiction to a part of foreign income of a non-resident company (not subject to tax in the UK) over which it had symmetrically not asserted any taxing jurisdiction.

This conclusion directly contradicts the basic and shared assumption on which all of the Court of Justice's case law in the field of direct taxation is based, i.e. the principle according to which Member States retain the power to determine the criteria for the levy of their taxes, with a view to defining tax jurisdiction and avoiding double taxation, which directly implies that Member States are also free to limit their taxing rights and, thus, to decide not to levy tax on certain taxpayers or types of income (as long as they do not do so in a discriminatory way). Which demonstrates once again the need for positive

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[338] Melis, G., *Perdite intracomunitarie, potestà impositiva e principio di territorialità: unicuique suum?*, in Rassegna Tributaria, 2008, 1486.

[339] Wathelet, M., *Tax sovereignty of the Member States and the European Court of Justice: new trends or confirmation?*, cited above, 915. See also Vanistendael, F., *Ability to pay in European Community law*, cited above, 130, where the Author states that the statement of the Court on "final losses" "*looks like a Pyrrhic victory for the principle, guaranteeing legal guerrilla litigation by national tax administration demanding absolute certainty from their national courts that the losses cannot be used anywhere else in the world*".

harmonisation at the EU legislative level, at least with regards to cross-border corporate loss relief[340], which would certainly be preferable to the "creation of taxing rights" on the part of the Court of Justice.

It has been correctly argued that in the *Marks & Spencer* judgement overcoming discrimination meant overcoming the consistent application of territoriality or "fiscal symmetry" in the allocation of taxing rights amongst Member States as it had been settled in the *Futura* case, according to which, if a Member State does not tax the profits produced abroad, it does not have to allow deductions of costs or losses incurred abroad. This statement had been supported by legal doctrine also by resorting to the concept of economic allegiance and to the general prohibition of extraterritorial taxation[341].

It should also be observed, in light of all that has been discussed in the previous Chapter of this research, that the Court's definition of territoriality as a principle "*enshrined in international tax law*" is highly questionable. Several authors have, in fact, highlighted that, by concluding tax treaties, contracting states agree to restrict their powers in exercising their tax rights, by way of rules that considerably vary between different types of income (and different taxes) and between different bilateral conventions. Therefore, since the sole expression of "international tax law" is constituted by the network of tax treaties concluded by countries, and given the fact that the contents of such treaties depend on the negotiating powers of the contracting states, "international tax law" does not seem to be based on principles at all and that territoriality cannot be seen as a "principle of international tax law"[342].

It is also interesting to highlight that Advocate General Maduro, in his Opinion on the *Marks & Spencer* case, had specifically considered the point of territoriality and defined the meaning of the "principle of territoriality" from the perspective of the Court of Justice, stating that it was the principle according to which the Court "*recognises merely the need to take account of constraints resulting from the fact that Member States are equally sovereign in tax matters* [and should, therefore] *reach an accommodation with States enjoying equal sovereignty in tax matters*", but that it cannot "*be invoked to enable the Member States to evade their obligations under Community law*".

This view of the principle of territoriality and of its relevance in the context of European Union law was then picked up by the Court in subsequent judgements. For

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[340] After the *Marks & Spencer* judgement, the Commission published a Communication on *Tax treatment of losses in cross-border situations* (Commission from the Commission to the Council, the European Parliament and the Economic and Social Committee, 19 December 2006, COM(2006)824, where it encouraged Member States to adopt unilateral measures as regards cross-border loss relief within group of companies.
[341] Brauner, Y., Dourado, A.P., Traversa, E., *Ten years of Marks & Spencer*, in Intertax, 2015, 4, 308.
[342] Lang, M., *The Marks & Spencer case. The open issues following the ECJ's final word*, cited above, 60.

example, the Court, in the *Busley* decision, stated that the purpose of the principle of territoriality is "*to establish, in the application of Community law, the need to take into account the limits on the Member States' powers of taxation*"[343]. It should, however, be noted that, notwithstanding this definition, the Court, has subsequently proposed, e.g. in its *Commission v. Belgium* decision, a partially different definition of "territoriality", defined as the notion according to which fiscal systems "*coexist without a hierarchy between them*"[344], which basically amounts to the idea underlying the "parallel exercise of taxing powers" doctrine, which we will analyse in the following pages of this study, even though, in that case, the Court ruled on a point of cohesion as justification for discriminating domestic measures.

Notwithstanding the issue of the above-mentioned vagary attitude of the Court towards the topic of the definition of the concept of "territoriality", part of legal scholarship welcomed the *Marks & Spencer* judgement as a step forward towards an "European fiscal Union", hoping to be witnessing the birth of a new principle according to which, in the event of a difference in treatment between purely domestic situations and cross-border ones, a taxpayer should be allowed to take advantage of a tax benefit wherever he/she/it is located, as a direct consequence of the confirmation of the "*Schumacker* doctrine"[345]. In other terms, supporters of the *Marks & Spencer*'s approach have found that the "*Futura* doctrine" does not serve the purpose of reaching a more integrated Internal Market and agreed with AG Poiares Maduro in stating that, whereas the need to ensure cohesion may justify restrictive rules, cohesion cannot, however, go to the detriment of integration of tax systems within the context of the Internal Market. Therefore, a vision of territoriality as that which is typical of international law, greatly relying on national sovereignty, may not be adequate for the European Union context and for the purposes of the Internal Market.

What is certain is that deducting in the source Member State costs incurred by a non-resident without a permanent establishment means overcoming the traditional role of the source country with regards to non-residents.

It also seems certainly correct to say that, to a certain extent, the *Marks & Spencer* decision contradicts the "*Kerckhaert Morres* doctrine", which has been already mentioned above and which will be analysed in the next paragraph[346], meaning that the idea of an "always somewhere approach" such as that adopted by the Court in the *Marks & Spencer*

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[343] Court of Justice of the European Union, 15 October 2009, C-35/08, *Busley*, par. 30.
[344] Court of Justice of the European Union, 1 December 2011, C-250/08, *Commission v. Belgium*.
[345] Wathelet, M., *Tax sovereignty of the Member States and the European Court of Justice: new trends or confirmation?*, cited above, 913.
[346] See Chapter II, paragraph 6.

judgement goes against the logic on which the Luxembourg Judges founded their statement according to which double taxation of the same item of income, in absence of any relevant discrimination, is merely the result of the parallel exercise of taxing jurisdictions on the part of the Member States. Authors have argued that the Court of Justice, with its *Marks & Spencer* decision, has demonstrated having some difficulties accepting the "other side" of the coin that is the "*Kerckhaert Morres* doctrine", namely that the parallel exercise of taxing powers on the part of the Member States may also result in irremediable double non-deductibility of certain charges or losses.

The "final losses" criterion established in *Marks & Spencer* has been upheld in various subsequent decisions of the Court of Justice as well[347], but nonetheless it has also been the object of considerable criticism, especially with regards to the uncertainty it is able to produce in practical terms (when is it possible to really consider a loss as "final"?) and also because, in subsequent judgements, the Court of Justice seemed to deny such a criterion, with an apparent denial of its "always somewhere approach".

The Court, in fact, took a partially different approach than the one adopted in *Marks & Spencer* in its *X Holding* judgement[348], concerning the Dutch "single entity taxation" regime. The decision started its reasoning by quoting its ruling in *Schumacker*, stating that "*in tax law, the taxpayers' residence may constitute a factor that might justify national rules involving different treatment for resident and non-resident taxpayers. However, that is not always the case. To accept that the Member State of establishment may in all cases apply different treatment because the registered office of a company is situated in another Member State would deprive Article 43 EC of its substance*". However, according to the Court, "*the situation of a resident parent company wishing to form a single tax entity with a resident subsidiary and the situation of a resident parent company wishing to form a single tax entity with a non-resident subsidiary are objectively comparable with regard to the objective of a tax scheme such as that at issue in the main proceedings in so far as each seeks to benefit from the advantages of that scheme*".

This reasoning has been much criticised by legal doctrine. It has been observed, in fact, that considering parent companies of non-resident subsidiaries (not subject to tax) comparable to parent companies of resident subsidiaries (subject to tax) only on the ground of the fact that both seek to benefits from the advantages of the scheme at issue is

[347] See, for example, Court of Justice of the European Union, 3 February 2015, C-172/13, *Commission v. United Kingdom*; Court of Justice of the European Union, 17 December 2015, C-388/14, *Timac Agro Deutschland GmbH*. For a comment on the point, see Pinetz, E., Spies, K., *'Final losses' after the decision in Commission v. UK (Marks & Spencer II)*, in EC Tax Review, 2015, 6, 309.
[348] Court of Justice of the European Union, 25 February 2010, C-337/08, *X Holding*. For a comment of the judgement, see Van Thiel, S., Vascega, M, *X Holding: why Ulysses should stop listening to the siren*, in European Taxation, 2010, 8, 334.

not a strong enough argument to limit the Member States' sovereign powers in the design and allocation of their fiscal jurisdiction on the ground of the "source" and "residence" criteria[349].

Notwithstanding this, the Court found the Dutch measure to be justified by the need to safeguard the allocation of taxing powers amongst Member States and proportionate because, unlike residents, non-residents are not subject to tax. More specifically, the Court stated that "*Articles 43 EC and 48 EC do not preclude legislation of a Member State which makes it possible for a parent company to form a single tax entity with its resident subsidiary, but which prevents the formation of such a single tax entity with a non-resident subsidiary, in that the profits of that non-resident subsidiary are not subject to the fiscal legislation of that Member State*". According to the Court, the exclusion of non-resident companies from such a scheme is justified by the need to safeguard the balanced allocation of taxing powers amongst Member States, since "*the possibility of including a non-resident subsidiary in the single tax entity would be tantamount to granting the parent company the freedom to choose the tax scheme applicable to the losses of that subsidiary and the place where those losses are taken into account*".

On this point, it has been noted that what was denied at the first step of the "rule of reason test" employed by the Court, where the Court deemed residents which were subject to tax and non-residents which were not subject to tax comparable, became decisive in the third step of said test[350]. It could even be argued that, in *X Holding*, the territoriality argument (which, in *Futura*, was taken into account in the first step of the "rule of reason test", stating that a tax system compliant with the fiscal principle of territoriality could not constitute a breach of EU law, and which, subsequently, has been considered in the context of the second step of said test, as a possible justification for a discriminatory measure) was "moved" to the "very bottom" of the Court's analysis, i.e. to the third step of the "rule of reason": if a discriminatory or restrictive tax measure could be justified, and then complies with the principle of territoriality, it follows that it constitutes a proportionate measure.

The Court then clarified the scope of application of the principles voiced in *X Holding*, for example, in its more recent *Groupe Steria* judgement[351], where it stated that it cannot be inferred from the *X Holding* decision that any difference in treatment between companies belonging to a tax-integrated group and companies not belonging to such a

[349] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 545.
[350] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 546.
[351] Court of Justice of the European Union, 2 September 2015, C-386/14, *Groupe Steria SCA*. For a comment on the case, see Korving, J., *Groupe Steria: a threat to group taxation regimes?*, in EC Tax Review, 2016, 1, 40.

group is admissible under the Treaty freedoms, since the *X Holding* judgement only concerned the condition of residence as a condition for having access to a tax integration scheme. Therefore, according to the Court, "*as regards tax advantages other than the transfer of losses within the tax-integrated group, a separate assessment must be made […] as to whether a Member State may reserve those advantages to companies belonging to a tax-integrated group and consequently exclude them in cross-border situations*".

5.1. After *Marks & Spencer*: the evolution of the "always somewhere" approach from an "overall" perspective.

The Court of Justice's case law on cross-border loss relief and group taxation has probably constituted the maximum level of expansion of the "interventionism" of the Court in direct tax matters, with its "always somewhere" doctrine forcing Member States to modify the extension of their fiscal jurisdiction, also disregarding the consequences of the traditional territorial allocation of taxing powers according to which a certain level of symmetry is applied when deciding which foreign income to levy tax on. This kind of approach appears to be the result of the maximum degree of expansion of the interpretation of fundamental Treaty freedoms as an expression of the principles of equality and non-discrimination, elevating the analysis of the Court to a genuinely European level and concerning the examination and evaluation of the effects played by tax measures from at least two Member States[352].

In other terms, the Court of Justice, in the name of the reasoning generally known as "always somewhere approach", has forced Member States to extend their fiscal jurisdictions to items of income they had excluded. Aside from the fact that, in doing so, the Court effectively traces the limits of the Member States' tax jurisdictions and allocates positive and negative items of income to different jurisdictions, which is something that (as the Court itself has recognised more than once) is generally left to the political decisions of said Member States, it has been argued that such an approach actually disrupts the tax base coherence between connected negative and positive elements of income[353].

However, the "always somewhere" approach as developed in the *Marks & Spencer* decision has not always been applied in a consistent manner by the Court of Justice, leading, once again, to some doubts and uncertainties as to the scope of application of

[352] Bizioli, G., *Aporie e contraddizioni della giurisprudenza europea in material di exit taxation*, in Riv. dir. fin. sc. fin., 2014, 3, 390.
[353] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 466.

the justification based on the "balanced allocation of taxing powers".

On the point, for example, in the context of corporate group taxation, the *Oy AA* case[354], concerning restrictions on the deductibility of profits transferred from a subsidiary to its parent company, is certainly worth mentioning. Pursuant to the regime at issue, taxable profits could be transferred to other companies belonging to the same group, so as to achieve a more "global" offsetting of profits and losses on a group scale, only if both the contributor and the recipient were fiscally resident in the Member State at issue (Finland).

In examining the compatibility of such a measure with European Union law, the Court has expanded on its "*Marks & Spencer* approach" to the issue, emphasising that, in absence of harmonising European Union measures in the field of direct taxation, "*Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation*"[355], but that the justification based on ensuring the balanced allocation of taxing powers amongst Member States might be allowed only if "*the system in question is designed to prevent conduct capable of jeopardising the right of the Member States to exercise their taxing powers in relation to activities carried on in their territory*"[356].

Starting from these assumptions, the Court ruled that, even though the regime at issue constituted a restriction of the freedom of establishment, such a restriction was justified by the need to safeguard the balanced allocation of taxing powers combined with the need to prevent tax avoidance. This conclusion basically enforces territorial taxation, even though territoriality (or the balanced allocation of taxing powers) is seen as not sufficient *per se* and as needing to be combined with anti-avoidance purposes. The point will be further developed in the following pages of the research[357].

A partially different approach, more similar to the *Marks & Spencer* ruling, has been taken by the Court in the *Lidl Belgium* case[358] , which concerned a German resident company whose permanent establishment located in Luxembourg suffered some losses, which were deemed as non-deductible in German from the head company's income.

In this case, the Court ruled in favour of the compatibility of the regime with European Union law because considered the measure justified by the need to ensure a balanced allocation of taxing powers amongst Member States combined with the need to prevent the risk of "double dip"[359]. It also reiterated that a measure restricting the

[354] Court of Justice of the European Union, 18 July 2007, C-231/05, *Oy AA*.
[355] Court of Justice of the European Union, 18 July 2007, C-231/05, *Oy AA*, par. 58.
[356] Court of Justice of the European Union, 18 July 2007, C-231/05, *Oy AA*, par. 59.
[357] See Chapter II, paragraph 7.
[358] Court of Justice of the European Union, 15 May 2008, C-414/06, *Lidl Belgium*.
[359] Many authors have criticised the ruling given on the *Lidl Belgium* case from this viewpoint, highlighting that the risks of double deduction of losses are less relevant with regard to permanent establishment than with concern to

freedom of establishment only goes beyond what is necessary to attain its legitimate objectives where it denies deduction of foreign losses even though a non-resident subject has exhausted the possibilities for having those losses taken into account in the future in the Member State where they originated (which was not the case in the fact pattern examined by the Court in *Lidl Belgium*). The Court has, therefore, accepted the immediate cash flow disadvantage as an acceptable consequence of the allocation of taxing powers according to territoriality[360].

In its subsequent decision on the *Philips Electronics* case[361], concerning, once again the United Kingdom's group relief regime, the Court of Justice assessed again the question whether or not a restriction on freedom of establishment can be justified on the grounds of the need to preserve the balanced allocation of taxing powers amongst Member States, holding that the balanced allocation justification has the purpose to safeguard the symmetry between the right to tax profits and the right to deduct losses[362], but that it could not be used as a justification in the case at issue because the power of the Member State of source to impose taxes "*on whose territory the economic activity giving rise to the losses of the permanent establishment is carried out […] is not at all affected by the possibility of transferring, by group relief and to a resident company, the losses sustained by a permanent establishment situated in its territory*".

The "always somewhere" approach was also confirmed by the Court in the much criticised *Deutsche Shell* judgement[363]. The case dealt with a currency loss on the working capital contribution granted by a German company to its Italian branch (permanent establishment) and that was qualified by the Court of Justice as a "*specific operational factor which is capable of being taken into consideration only by the German tax authorities*", which led the Judges to state that "*it is unacceptable for a Member State to exclude from the basis of assessment of the principal establishment currency losses which, by their nature, can never be suffered by the permanent establishment*"[364].

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foreign subsidiaries, since permanent establishments do not enjoy juridically separate personality from that of their head companies. It has, therefore, been argued that the application of the *Marks & Spencer* reasoning to this case as well was not completely on point. Of this opinion is, for instance, Monsenego, J., *Taxation of foreign business income within the European Internal Market*, cited above, 445.

[360] Marres, O., *The principle of territoriality and cross-border loss compensation*, cited above, 118.

[361] Court of Justice of the European Union, 6 September 2012, C-18/11, *Philips Electronics*. For a comment on the judgement, see Monteiro, R., Kiers, M., *The Court's position on cross-border losses: a quest for the well-being of EU citizens?*, in EC Tax Review, 2013, 2, 92.

[362] Once again the difference between the justification based on "fiscal coherence" and that based on "the need to preserve a balanced allocation of taxing powers amongst Member States" becomes more and more blurred.

[363] Court of Justice of the European Union, 28 February 2008, C-293/06, *Deutsche Shell*.

[364] It should be noted that, from a strict corporate law perspective, it has been pointed out that, whereas a subsidiary is an entity which is distinct and separate from the parent company, a permanent establishment is only the expression of a *de facto* presence of a foreign company in another country, with no separate legal personality, which, according to some authors, implies that, in order to deny carry-over of losses suffered by a foreign permanent establishments, a stronger justification ground would be needed than in the case of foreign

In other words, according to the Court, since the currency loss at issue did not exist in Italy and since it had to be deductible somewhere, then it had to be deducted in Germany, notwithstanding the fact that Germany did not have any tax jurisdiction on the related currency gains. In reaching this conclusion, the Court rejected the arguments based on the coherence of the tax system, noting that there supposedly was no direct link between the currency gains and the currency losses, and on the need to preserve the balanced allocation of taxing powers amongst Member States, stating that a Member State cannot be required to take into account the negative elements connected to the income accrued on a permanent establishment located abroad only because those elements cannot be taken into account in the Member States where the permanent establishment is located, since Member States are not generally obliged to shape their tax regimes so as to avoid disparities with the tax regimes of other Member States.

In doing so, however, the Court actually compelled a Member State (Germany) to selectively assume fiscal jurisdiction when it had decided not to do so, forcing it to take into account, for the purposes of its tax law, items of income over which that Member State had no tax jurisdiction at all. In light of these considerations, it has been observed that the *Deutsche Shell* judgement constitutes another example of a decision through which the Court of Justice selectively allocated positive and negative items of income, disrupting the sovereign decisions taken by Member States even in absence of an actual discrimination.

6. Back to the basics: the "parallel exercise of taxing powers" doctrine.

After the "expansion" of the protection granted to the taxpayer's position with the application of the "always somewhere approach" with the *Marks & Spencer* strain of decisions and of the relevance of the parameter of ability to pay inaugurated with the "*Schumacker*" judgement, however, the Court of Justice seemed to retreat on more "conservative" positions, reiterating the statement of the primacy of the Member States' freedom in determining the borders of their fiscal jurisdictions, either unilaterally or by way of bilateral negotiation with other countries.

The main reference on the point is to the *Kerckhaert Morres* decision[365].

The case concerned a Belgian measures which applied the same tax rate to dividends irrespective of whether they came from Belgium or from France and of the

subsidiaries. On the point, see Wimpissinger, C., *Cross-border transfer of losses. The ECJ does not agree with Advocate General Sharpston*, in EC Tax Review, 2009, 179, and the authors cited therein.

[365] Court of Justice of the European Union, 14 November 2006, C-513/04, *Kerckhaert Morres*.

fact that France had already subjected such dividends to a first layer of taxation. It was, therefore, argued by the claimants that Belgian rule restricted free movement of capital as it failed, in taxing the French-source dividends, to take into account the French tax already levied.

The Court of Justice found the Belgian rule not to be discriminatory, to the extent that Belgium exercised tax jurisdiction over foreign-source and domestic-source dividends charging the same tax rates, thus ruling that the mere exercise in parallel by two Member States of their fiscal sovereignty and the consequent differences in treatment between purely domestic and cross-border circumstances, if each system is not *ex se* discriminatory, cannot be prohibited by the fundamental freedoms provided for by the Treaties, but can only be dealt with either by harmonisation measures at the European Union level or by bilateral or multilateral conventions between the Member States. Therefore, the disadvantage caused by the measure at issue in the *Kerckhaert Morres* case, resulting from the parallel exercise of fiscal sovereignty by two Member States, was not considered as constituting a breach of European Union law, since "*Community law, in its current state and in a situation such as that in the main proceedings, does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Community*" and, therefore, "*it is for the Member States to take the measures necessary to prevent situations such as that at issue in the main proceedings by applying, in particular, the apportionment criteria followed in international tax practice*".

In other terms, the Court essentially stated that the adverse consequences that might arise from a conflict of tax jurisdiction, that is to say the parallel exercise of fiscal sovereignty by two Member States, do not fall within the scope of the fundamental freedoms. It can be derived from this judgement that the fundamental freedoms only serve as broad prohibitions of discrimination addressing the source Member State and the Member State of residence separately and individually[366]. The underlying reasoning is that the adverse effect of simultaneous source taxation and residence taxation on the same item of income is not caused by one of the two jurisdictions and, therefore, not by discrimination, but rather by the parallel (and legitimate) exercise of taxing powers by

[366] Cordewener, A., *The prohibitions of discrimination and restriction within the framework of a fully integrated market*, cited above, 11. According to the Author, this would be "*the only way a non-discrimination principle can be handled within a legal framework that comes close to a federal system, i.e. a moltitude or regionally limited national legal orders (of the Member States) which are confronted with common rules contained in a higher legal order*". See also Cordewener, A., *Personal income taxation of non-residents and the increasing impact of the EC Treaty freedoms*, cited above, 67; Garabedian, M., Malherbe, J., *Cross-border dividend taxation: testing the Belgian rules against the ECJ case law (or testing the ECJ case law against the Belgian rules)*, in Hinnekens, L., Hinnekens, P. (eds.), *A vision of taxes within and outside European borders*, The Hague, 2008, 397; Quaghebeur, M., *Kerckhaert Morres revisited: ECJ to reconsider Belgian taxation of inbound dividends*, in Tax Notes International, 2008, 9, 931.

two jurisdictions.

This reasoning is in line with the Opinion AG Geelhoed had expressed with regards to the same *Kerckhaert-Morres* case, where he concluded that the mere fact that the Member State of residence might not relieve double taxation is not contrary to the Treaty provisions on free movement as long as that Member State complied with the obligation not to discriminate between foreign-source and domestic-source income in exercising its jurisdiction. In the absence of any priority rule at the European Union level, any distortion of economic activities deriving from such a choice would be a mere consequence of the fact that, in the present situation of EU law, different tax systems coexist and "*this means disadvantages for economic actors in some cases and advantage in others*"[367]. Ultimately, in the AG's opinion, the possibility of such disadvantages may not be challenged under the fundamental freedoms, first of all because Member States still have the power to choose the criteria for the allocation of their taxing powers and also because no alternative criteria for such an allocation of tax jurisdiction can be derived from European Union law.

According to this reasoning - which, on a purely theoretical juridical level, seems to be essentially correct - disparities arise because different national tax systems apply to the same factual circumstance independently from one another: this is what has been argued in the previous chapter of the research when we demonstrated the absence of any actual binding principle for the allocation of taxing powers amongst countries at the international level[368]. It is, in fact, a "corollary" of the affirmation of state sovereignty to acknowledge that a country (even a Member State) may freely limit its tax jurisdiction (e.g. choosing not to tax a certain item of income) and that taxation on the part of a country is not linked to taxation on the part of another country. If disparities were prohibited because they restrict the exercise of the freedoms of movement within the Internal Market, this would amount to rethinking state sovereignty in a field, such as direct taxation, in which the European Union has no exclusive competence, by linking a country's taxing rights to the ways in which another country chooses to exercise (or not to exercise) its fiscal jurisdiction. This would also imply that the Court of Justice would have to take political decisions, which belong to state sovereignty, thus contradicting its basic assumption according to which competence with regard to direct taxation lies with the Member States; and it would do so by exercising its judicial powers, imposing an

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[367] Court of Justice of the European Union, Advocate General Geelhoed's Opinion, 6 April 2006, C-513/04, *Kerckhaert Morres*, par. 36. See also Kofler, G., *Fundamental freedoms and juridical double taxation*, cited above, 34.
[368] Van de Vijver, A., *International double taxation in the European Union: comparative guidelines from Switzerland and the United States*, cited above, 15.

integration of national tax systems by way (not of a legislative decision, but) of judgements which are necessarily rendered on specific cases.

It should incidentally be noted that, even though the Court clarified this reasoning in explicit terms for the first time in *Kerckhaert-Morres*, it had previously hinted to the legitimacy of the effects caused by the parallel and autonomous exercise of taxing powers by Member States, for which there would be no remedy pursuant to European Union law other than harmonisation of the divergent national regimes, for the first time in its *Peralta* judgement[369]. Similar statements had also been made by the Court, for example, as far as taxation is concerned, in the *Schempp* judgement[370], where the Judges have acknowledged that "*the Treaty offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation. Given the disparities in the tax legislation of the Member States, such a transfer may be to the citizen's advantage in terms of indirect taxation or not, according to circumstances*"[371].

The Court has also drawn similar conclusions with regards to corporations as well, e.g. in its *Krankenheim* judgement[372], where it argued that Member States are no under any obligation to coordinate their respective tax systems in order to make intra-EU transfers fiscally neutral[373]. An analogous argument, even though not as explicit as in *Kerckhaert Morres*, could also be found in the previous Court's judgemen on the *Gilly* case, where it had stated that "*although the abolition of double taxation within the Community is […] included among the objectives of the Treaty, it is clear from the wording of that provision* [i.e. previous Article 220 of the EEC Treaty] *that it cannot itself confer on individuals any*

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[369] Court of Justice of the European Union, 14 July 1994, C-379/92, *Criminal proceedings against Matteo Peralta*. More specifically, the Court, in that occasion, had stated that "*in the absence of Community harmonisation, a Member State may certainly impose, directly or indirectly, technical rules which are specific to it and which are not necessary to be found in the other Member State on maritime transport undertakings which, like the undertaking employing Mr. Peralta, are established on its territory and which operate vessels flying its flag. But the difficulties which might arise for those undertakings from that situation do not affect freedom of establishment within the meaning of the Treaty. Fundamentally, those difficulties are no different in nature from those which may originate in disparities between national law governing, for example, labour costs, social security costs or the tax system*".

[370] Court of Justice of the European Union, 12 July 2005, C-403/03, *Egon Schempp v. Finanzamt München V*.

[371] For a similar statement, see also Court of Justice, 29 April 2004, C-387/01, *Wiegel*. The Court of Justice of the European Union has dealt with the topic several times in non-tax cases as well, such as in the *Perfili* judgement (1 February 1996, C-177/94, *Criminal proceedings against Gianfranco Perfili*), where it held "*that, in prohibiting every Member State from applying its law differently on the ground of nationality, within the field of application of the Treaty, Articles 12, 43 and 49 EC are not concerned with any disparities in treatment which may result, between Member States, from differences existing between the laws of the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality*".

[372] Court of Justice of the European Union, 23 October 2008, C-157/07, *Krankenheim Ruhesitz*.

[373] More specifically, the Court stated, in *Krankenheim*, that "*a Member State cannot be required to take account, for the purposes of applying its tax law, of the possible negative results arising from particularities of legislation of another Member State applicable to a permanent establishment situated in the territoru of the said State […] Freedom of establishment cannot be understood as meaning that a Member State is required to draw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, taxation which removes any disparities arising from national tax rules, given that the decisions made by a company as to the establishment of commercial structures abroad may be to the company's advantage or not, according to circumstances*".

rights on which they might be able to rely before their national courts"[374]. In the *D. v. Inspecteur* judgement[375], furthermore, the Court explicitly stated that Member States are free to determine the connecting factors for the purposes of allocating their taxing powers and that the Court accepts that "*a difference in treatment between nationals of the two Contracting State that result from that allocation cannot constitute discrimination*".

The somehow uniform application of such a reasoning on the part of the Luxembourg Judges has led legal scholars to trace a consistent distinction, in the analysis of the Court of Justice's case law on discrimination and compatibility of Member States' tax measures with Treaty freedoms, between the two concepts of "discrimination" (and restriction) and of "disparity"[376]. According to the Court's approach, discriminations have their origin within a single jurisdiction, occurring where a disadvantage or hindrance to the exercise of the Treaty freedoms is caused as a consequence of the (tax) provisions of a single Member State directly or indirectly distinguishing between purely domestic situations and comparable cross-border situations. Such discriminations are generally prohibited, according to the Court's case law, if they cannot be properly justified or are disproportionate.

Disparities, on the other hand, depend on the interactions between two different Member States' regimes. In other words, disparities are possible obstacles to free movement caused by differences between the legal systems of two (or more) Member States. On this point, the Court holds that disparities, such as those created by the parallel exercise of taxing powers by Member States, are outside the scope of application of the Treaty freedoms, because, otherwise, Member States' sovereignty in levying direct taxes would be at risk, with the Court being force to make choices falling within the political sovereignty of the Member States[377].

However, the so-called "*Kerckhaert Morres* approach" has been criticised not only by the Commission itself[378], but also by a large part of legal scholarship[379], arguing, in brief,

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[374] Court of Justice, 23 May 1998, C-336/96, *Gilly*.
[375] Court of Justice of the European Union, 5 July 2005, C-376/03, *D. v. Inspecteur*.
[376] On the point, see, amongst others, Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, *passim*.
[377] See, amongst others, Weber, D., *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, cited above, 588, according to which "*since two Member States are involved when a disparity arises, the ECJ will have to decide which Member State is being restrictive and will thus have to choose which of the taxation rights takes priority. Because Community law respects Member States' sovereignty in direct tax matters, disadvantages resulting from disparities should not be contrary to the Treaty freedoms*".
[378] Commissioner Kovacs reportedly noted that in the *Kerckhaert Morres* judgement the Court failed to take into account the Internal Market issue. See Kofler, G., *Fundamental freedoms and juridical double taxation*, cited above, 36.
[379] Rainer, A., *ECJ decides on withholding taxes on cross-border income*, in Intertax, 2007, 63; Kofler, G., Mason, R., *Double taxation: a European switch in time?*, in Columbia Journal of European Law, 2007, 67; Van Thiel, S., *Why the European Court of Justice should interpret directly applicable Community law as a right to most-favoured nation treatment and a prohibition of double taxation*, in Weber, D. (ed.), *The influence of European law on direct taxation. Recent and future developments*, The Hague, 118; Vanistendael, F., *In defence of the European Court of Justice*, cited above, 90; Vanistendael, F., *Does the ECJ have the power of interpretation to build a tax system compatible with the fundamental*

that international double taxation, though tolerated by the Court of Justice - which seems to be satisfied simply if both Member States involved refrain from distinguishing between cross-border situations and comparable purely domestic situations - constitutes one of the most relevant obstacles to free movement within the Internal Market.

It has also been observed that the traditional Court's case law concerning non-tax matters strongly indicates that the interplay between the legal systems of two Member States may generate forbidden obstacles to the proper functioning of the Internal Market, leading to situations where indistinctly applicable rules of a Member State (i.e. non-discriminatory measures) create an unequal impact on cross-border situations, by way of the imposition of a double regime of rules[380]. In non-tax cases[381], the Court has tried to overcome the friction created by legislative disparities between Member States, constituting prohibited hindrances to the functioning of the Internal Market, by adopting the principle of mutual acceptance and recognition to solve the problems cause by the interaction of the legislations of the Member States involved. In doing so, the Judges have found the *ratio* of such a reasoning in the fact that the Treaty requires not only the elimination of all discrimination on the ground of nationality, but also the abolition of any restriction, even if applying without distinction both to nationals and non-nationals, liable to prohibit, impede or render less advantageous or attractive cross-border initiatives on the part of EU citizens. The same authors voicing this opinion, however, generally recognise that the mutual recognition principle may not be easily transposed into the field of direct taxation[382].

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freedoms?, in EC Tax Review, 2008, 52; Isenbaert, M., *The ECJ condones Belgian personal income taxation of dividends. A temporary state of affairs?*, in EC Tax Review, 2007, 236; Snell, J., *Non-discriminatory tax obstacles in Community law*, in International and Comparative Law Quarterly, 2007, 361.

[380] Kofler, G., *Fundamental freedoms and juridical double taxation*, in Bizioli, G. (ed.), *Essays in international and European tax law*, Naples, 2010, 14; see also Farmer, P., *The Court's case law on taxation: a castle built on shifting sands?*, in EC Tax Review, 2003, 75, and the authors cited therein; Englisch, J., *The European Treaties' implications for direct taxes*, in Intertax, 2005, 324; Lang, M., Englisch, J., *A European legal tax order based on ability to pay*, in Amatucci, A. (ed.), *International tax law*, The Hague, 2006, 251; Hinnekens, L., *AMID: the wrong bridge or a bridge too far? An analysis of a recent decision of the European Court of Justice*, in European Taxation, 2001, 206.

[381] Reference is especially made to cases on free exchange of goods between Member States, requirements for the import of foreign goods, services provided by foreign suppliers and social security legislation. See, for example, Court of Justice of the European Union, 20 February 1979, 120/78, *Rewe-Zentral AG ("Cassis de Dijon")*; Court of Justice of the European Union, 2 December 1999, C-234/97, *Fernandez*; Court of Justice of the European Union, 7 May 1991, C-340/89, *Vlassopoulou*; Court of Justice of the European Union, 30 November 1995, C-55/94, *Gebhard*; Court of Justice of the European Union, 15 February 1996, C-53/95, *Kemmler*; Court of Justice of the European Union, 3 February 1982, joined cases 62/81 and 63/81, *Seco*; Court of Justice of the European Union, 28 March 1996, C-272/94, *Guiot*; Court of Justice of the European Union, 23 November 1999, joined cases C-369/96 and C-376/96, *Arblade*. On the point, see also Wattel, P.J., *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power: what is the difference?*, cited above, 146.

[382] Kofler, G., *Fundamental freedoms and juridical double taxation*, cited above, 22; Weber, D., *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, cited above, 582; Hinnekens, L., *The search for the framework conditions of the fundamental EC Treaty principles as applied by the European Court to Member States' direct taxation*, cited above, 112; Lyal, R., *Non-discrimination and direct tax in Community law*, in EC Tax Review, 2003, 68; Bizioli, G., *Il processo di integrazione dei principi tributari nel rapporto tra ordinamento costituzionale, comunitario e diritto internazionale*, Padua, 2008, *passim*; Bizioli, G., *Il principio di non discriminazione*, in Di Pietro, A., Tassani, T. (eds.), *I principi europei del diritto tirbutario*, Padua, 2013, 191.

It should also be noted that the issue of the restrictions to the exercise of Treaty freedoms posed by juridical double taxation would not be solved even in a hypothetical world where all Member States had identical tax systems in place[383]. This is even more true if we consider that, as highlighted in the first chapter of the present research, general public international law hardly poses any limit to the sovereignty of countries in designing the borders of their fiscal jurisdictions and in allocating their taxing powers.

This is the dilemma on which the focus has been for some time, as a consequence of the Court's struggle to reconcile two opposite views, i.e., on one hand, the fact that, as far as tax law is concerned, there is an undeniable considerable difference than the one between being subject to tax or not being subject to tax or between being subject to only one country's tax law and being subject to more than one country's tax law - which, as long as there are no distributive rules at European Union level, can freely determine the limits of their tax jurisdictions - and, on the other hand, the fact that if the cross-border character of the income at issue were to be accepted as lawfully implying a higher level of taxation on the taxpayer, then said taxpayer would have little incentive to exercise his/her/its Treaty freedoms. And, as has been correctly observed, the Member States would have little incentive to undo, either by way of unilateral measures or through bilateral conventions, restrictive taxation of cross-border situations as compared to purely domestic ones[384].

Then again, denying direct applicability of the fundamental Treaty freedoms to juridical double taxation on the grounds that European Union law lacks criteria to allocate taxing powers amongst Member States also seems to ignore the fact that, in other cases concerning direct taxation, the Court actually divided fiscal jurisdiction amongst Member States, despite the absence of any European Union "guideline" on the point[385].

Notwithstanding such strong criticism, the Court has subsequently confirmed its "*Kerckhaert Morres* approach" in similar cases, such as *Damseaux*, *Columbus Container Services*, *Block* and *Leby-Sabbag*[386], where the Luxembourg Judges have essentially

[383] Kemmeren, E.C.C.M., *Principle of origin in tax conventions*, cited above, 246. Of the same opinion is also, amongst others, AG Geelhoed (Opinion on Case C-374/04, *ACT Group Litigation*, 23 February 2006), who recognised that, even if all Member States had completely non-discriminatory tax systems and even if they all had identical tax systems, double taxation would still be present in the Internal Market, since taxation based on source and residence would still remain in place in the jurisdictions concerned and the tax measures would still continue to overlap. Even more clearly, AG Colomer has stated that "*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*" (Opinion on Case C-376/03, *D.*, 26 October 2004).
[384] Wattel, P.J., *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power: what is the difference?*, cited above, 141.
[385] Kofler, G., Mason, R., *Double taxation: a European switch in time?*, cited above, 80.
[386] Court of Justice of the European Union, Order of the Court, 19 September 2012, C-540/11, *Levy-Sabbag*, where the Court found that "*dans la mesure où le droit communautaire, tel qu'applicable à la date des faits en cause dans l'affaire au principal, ne prescrit pas de critères généraux pour la répartition des compétences entre les États membres s'agissant de*

recognised the existence of a fiscal disadvantage resulting from juridical double taxation, but nonetheless ruled that this disadvantage is nothing more than the result of the exercise in parallel by the two Member States concerned of their fiscal sovereignty, thus not falling within the scope of the restrictions prohibited by the fundamental freedoms.

More in detail, the *Damseaux* case[387] concerned a dividend payment by a French company to an individual residing in Belgium; France had levied a withholding tax on such payment and Belgium levied tax on the income belonging individual taxpayer residing in its territory and, therefore, on the cross-border dividend payment received as well. The Court ruled that, *"in the absence of any unifying or harmonising measure at European Union level, Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation"*, since *"it is for the Member States to take the measures necessary to prevent […] double taxation by applying, in particular, the criteria followed in international tax practice"*. According to the Court's reasoning, if both the Member State of residence and the Member State of source are liable to tax the dividends at issue, it cannot be held that, under European Union law, it is necessarily for the Member State of residence to prevent or eliminate the prejudicial effects of double taxation because that would amount to granting a priority with respect to the taxation of such income to the Member State of source and European Union law (aside from the Directives on particular aspects of corporate tax) does not currently lay down any general criteria for the attribution of competence amongst Member States in relation to the elimination of double taxation within the Internal Market and to the allocation of taxing powers amongst Member States[388]. It follows that the Treaty freedoms do not contain any indication as to any priority of assumption of taxing jurisdictions or as which of the Member States involved should yield to the other Member State's taxing power; and, furthermore, that the Treaties do not require Member States to adapt their direct tax systems to fit the direct

l'élimination des doubles impositions à l'intérieur de la Communauté, l'article 56 CE, lu en combinaison avec les articles 10 CE et 293 CE, doit être interprété en ce sens qu'il ne s'oppose pas à une situation dans laquelle l'État membre, qui s'est engagé, par une convention bilatérale préventive de la double imposition à établir un mécanisme tendant à éliminer une telle imposition des dividendes, supprime ensuite ce mécanisme par une modification législative ayant pour effet de réintroduire une double imposition".

[387] Court of Justice of the European Union, 16 July 2009, C-128/08, *Damseaux*.

[388] These principles were clearly reiterated in the *Block* case (Court of Justice of the European Union, 12 February 2009, C-67/08, *Block*), concerning double taxation with regards to inheritance tax, where the Judges stated that *"Community law, in the current stage of its development […] does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the European Community. Consequently […] no uniform or harmonisation measure designed to eliminate double taxation has as yet been adopted at Community law level. […] It follows […] that, in the current stage of development of Community law, the Member States enjoy a certain autonomy in this area provided they comply with Community law, and are not obliged therefore to adapt their own tax systems to the different systems of tax of the other Member States in order, inter alia, to eliminate the double taxation arising from the exercise in parallel by those Member States of their fiscal sovereignty and, in consequence thereof, to allow the inheritance tax paid in a Member State other than that in which the heir is resident to be deducted in a case such as that of the main proceedings"*.

tax systems of other Member States, nor do they guarantee that the cross-border exercise of Treaty freedoms will always be neutral for tax purposes.

In other words, according to the Court, disadvantages resulting from differences in the scope of subjection to tax of non-residents and of income having its source in foreign territories are, in principle, outside the scope of application of the Treaty fundamental freedoms, provided non-residents and foreign-source income are not subject to more burdensome tax measures than residents and domestic-source income[389]. Stating otherwise would entail, according to the Court, granting a Member State priority in levying taxes on a certain item of income, which European Union law cannot do (yet).

On the other hand, one could argue that a hypothetical allocation of fiscal jurisdiction amongst Member States granting the Member State of source "priority to tax" could be seen as compliant with international juridical practice and, more specifically, with the system created by the OECD Model Convention and its Commentary. Nonetheless, it should be remembered that the Court of Justice has clarified that, even though the OECD Model Convention an expression of "international juridical practice", the interpretation of European Union law does not provide any leeway for general criteria for the allocation of taxing powers amongst Member States, not even in order to prevent or alleviate international double taxation of cross-border income, which is generally recognised as capable of hindering the exercise of Treaty freedoms and, therefore, the functioning of the Internal Market[390].

A similar approach has been adopted by the Court in the *Truck Center* judgement[391]. In its analysis of the case, the Court did not find any restriction or discrimination to be entailed by a tax regime which provided for a different treatment of foreign creditors by way of withholding tax in the source Member State as compared to domestic creditors, which were taxed by assessment according to that State's corporation tax, since, according to the Judges, that difference in treatment depended, on one hand, on the accepted difference between taxation at source by the Member State of source in respect of non-resident creditors and worldwide taxation by the Member State of residence in respect of domestic creditors and, on the other hand, on the difference in the position of the source Member State with regards to the possibility of recovery of the tax due. In that occasion, the Court also stated that such difference in treatment does not "*necessarily procure an advantage for domestic recipient companies*", thus placing restrictions

[389] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 61.

[390] Mason, R., *Tax discrimination and capital neutrality*, in World Tax Journal, 2010, 126; Traversa, E., *Il divieto di doppia imposizione*, cited above, 352.

[391] Court of Justice of the European Union, 22 December 2008, C-282/07, *Truck Center*.

resulting from indiscriminate taxation outside the possibility of scrutiny on the part of the Court[392].

However, the conclusions reached by the Court in *Truck Center* seem to largely clash with the approach taken by the Luxembourg Judges in other judgements, where the Court followed an entirely different approach, disregarding the above-mentioned difference between the position of "a Member State as residence country" and that of "a Member State as source country". On the point, reference should be made, for instance, to the *Commission v. Italy* decision[393]. The case concerned the different treatment that Italian tax law reserved to dividends distributed by Italian companies to other companies residing in Italy and to dividends distributed by Italian companies to non-resident companies[394]. First of all, the Court of Justice examined whether or not companies residing in Italy and companies residing in other Member States, if considered as the beneficiaries of the dividends at issue, should be seen as in comparable situations, finding that, in order to prevent non-resident companies from being limited in the exercise of their right to free movement of capital, the Member State of residence of the company distributing the dividends should ensure that non-resident companies receiving such dividends are granted a fiscal treatment which is similar to the one granted to resident receiving companies. Therefore, the Court found that, as Italy had decided to exercise its fiscal jurisdiction with regards to outbound dividends, non-resident companies receiving those dividends cannot but find themselves in a situation which is comparable to that of resident companies as far as the risk of economic double taxation was concerned. It followed that non-resident companies receiving dividends distributed by Italian companies should not be treated differently than Italian-resident companies receiving such dividends and the Italian tax provision at issue was considered as breaching EU law[395].

6.1. Derogations from the "parallel exercise" doctrine in certain fields of taxation of non-resident individuals.

Although, as it has been shown above, the Court has accepted that the prejudicial effects caused by the parallel exercise by Member States of their taxing powers are

[392] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 62.
[393] Court of Justice of the European Union, 19 November 2009, C-540/07, *Commission v. Italian Republic*.
[394] More specifically, Italian law exempted 95% of the amount of the dividends distributed to residen companies and subject the remaining 5% to tax pursuant to the regular corporate tax rate (at the time 33%), whereas outbound dividends distributed to non-resident companies were subject to a 27% withholding tax.
[395] A similar reasoning may be found also in judgements such as *Denkavit*, *Amurta* and *Aberdeen Property Investment*. On the point, see also Traversa, E., *Il divieto di doppia imposizione*, cited above, 345.

outside the scope of application of the Treaty freedoms, it seems reluctant to apply this sort of "*laissez-faire* approach", so to speak, when it may lead to double non-deductibility of cross-border losses, both for individuals and for corporations.

Speaking of personal allowances, an example of this rather contradictory attitude of the Court of Justice can be found in the *De Groot* judgement[396]. Ruling on that case, in fact, the Court required the Member State of residence of a migrant employee to grant him 100% of its personal tax allowances, even though that Member State exempted from taxation 66% of his income, on which tax was levied by the employment Member State. Therefore, since the Judges deemed it impossible for them to actually require the employment Member State to grant a proportion of the personal allowances provided by its tax law to the non-resident employee - even though the employment Member State fully taxed such employee on his domestic-source employment income - they ruled that the residence Member State had to recognise all of its personal allowances, irrespective of the proportion of income it had a right to tax, because, otherwise, the fact that the taxpayer had exercised its right to free movement would have led him to losing such allowances (which would have been granted in full had he had a job in his Member State of residence).

The starting point of the Court's reasoning was that, in absence of harmonisation, Member States are free to "*alter by way of bilateral or multilateral agreements […] that correlation between total income of residents and residents' general personal and family circumstances to be taken into account by the State of residence. The State of residence can therefore be released by way of an international agreement from its obligation to take into account in full the personal and family circumstances of taxpayers residing in its territory who work partially abroad*". However, the Court then considered that the Member State of residence of a migrant employee responsible for fully granting personal allowances could only be relieved of such obligation if that duty is fulfilled by the Member State of employment, either by virtue of a tax treaty or by way of unilateral measures.

More specifically, the Court found that "*the State of residence may […] be released from that obligation if it finds that, even in the absence of a convention, one or more of the States of employment, with respect to the income taxed by them, grant advantages based on the personal and family circumstances of taxpayers who do not reside in the territory of those States but receive taxable income there. However, the mechanisms used to eliminate double taxation or the national tax systems which have the effect of eliminating or alleviating double taxation must permit the taxpayers in the States concerned to be certain that as the end result, all their personal*

[396] Court of Justice of the European Union, 12 December 2002, C-385/00, *De Groot v. Inspecteur van belastingen*.

and family circumstances will be duly taken into account, irrespective of how those Member States have allocated that obligation amongst themselves, in order not to give rise to inequality of treatment which is incompatible with the Treaty provisions on the freedom of movement for workers and in no way results from the disparities between the national tax laws"[397].

In other words, since, in the Court's words, discriminatory taxation in one jurisdiction may be erased by corresponding tax reductions in another jurisdiction, it followed that the personal allowances at issue, according to the Court, had to be granted, somewhere: if not on the part of the source Member State, then at least in the Member State of residence[398].

Many authors have highlighted that, in its *De Groot* judgement, the Court has essentially "condemned the wrong Member State", i.e. the Member State which was not responsible for the discrimination and relieved the other Member State of its Treaty obligation, while it was the latter Member State which overtly discriminated against non-resident employees. The solution the Court resorted to in *De Groot* does not appear to be in line with the *Schumacker* judgement either: in *Schumacker*, in fact, the Court referred to the percentage of income earned by a non-resident subject in the Member State of source in order to force the Member State of source, and not the Member State of residence, to grant the non-resident subject the advantages granted to resident taxpayers.

It has been observed that, in reaching the above-mentioned conclusions, the Court has gone not only beyond the extension of its powers and its function, but also beyond the scope and meaning of the non-discrimination principle. This is because, in ruling as above, the Luxembourg Judges have disregarded the fact that the difference in treatment was not *per se* discriminatory in the sense which is prohibited by the Treaty, but resulted from the natural disparities existing between different tax systems at EU-level, which poses a problem that should be solved only by positive integration[399].

Another derogation to the general doctrine based on the "parallel exercise of

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[397] It should also be noted that the Court seems to have at least partially retracted the position expressed in *De Groot*, since, in the subsequent *Amurta* case (Court of Justice of the European Union, 8 November 2007, C-379/05, *Amurta*), it stated that "*the Netherlands cannot rely on the existence of a tax advantage granted unilaterally by another Member State in order to escape its obligations under the Treaty. However, it cannot be excluded that a Member State may succeed in ensuring compliance with its obligations under the Treaty through the conclusion of a convention for the avoidance of double taxation with another Member State*".

[398] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 465.

[399] Santiago, B., *Non-discrimination provisions at the intersection of EC and international tax law*, cited above, 259; according to the Author, it would be arguable that the existence of a discrimination being dependent on the taking into account of the tax treatment in the other Member State may not be compatible with the sovereign status of the Member States. The position is similar to the one held by Weber, D., *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, cited above, 585. *Contra*, Van Thiel, S., *Free movement of persons and income tax law. The European Court of Justice in search of principles*, Amsterdam, 2002, 373, according to whom the purpose of the non-discrimination principle in the field of taxation would be to prevent the imposition of an excessive tax burden on EU citizens and prevent them from enjoying unfair tax advantages in comparison with their ability to pay.

taxing powers" may be found, with regard to individual income taxation, in the subsequent *Renneberg* judgement[400]. The case dealt with a fact pattern that, *prima facie*, could seem to be similar to the fact pattern in *Schumacker*, but which, after a more careful analysis, shows significant points of difference. The taxpayer concerned resided in Belgium and had taken out a mortgaged loan therein in order to finance the acquisition of his home, which was also located in Belgium. Pursuant to Belgian law, mortgage interest could be deducted only from income deriving from real estate, which meant that the taxpayer concerned could only use a small part of the interest paid in order to reduce its Belgian tax base and wished to deduct the unused interest from his employment income, which he earned entirely in the Netherlands, where, by contrast, mortgage interest was deductible from the entire taxpayer's income, and not only from the part of that income deriving from real estate.

The Court, with a much criticised reasoning, applied its "*Schumacker* doctrine" and observed that the taxpayers concerned earned almost all of his income in the Netherlands, which made it comparable to a Dutch resident and that, therefore, he should be treated in the same way as Dutch residents in respect of all factors determining his personal ability to pay, which entitled him to deduct in the Netherlands the unused interest paid in relation to his mortgaged loan[401].

Legal doctrine has harshly criticised this solution, making reference to the fact that the Netherlands had no tax jurisdiction over foreign dwellings occupied by non-residents, together with the fact that the applicable double taxation convention between Belgium and the Netherlands allocated taxing rights on positive and negative items of income from real estate exclusively to the state where such real estate is located. Starting from these assumption, scholars have, convincingly, stated that there was no reason for the "parallel exercise of taxing powers" doctrine, based on the traditional interpretation of the "need to ensure the balanced allocation of taxing powers amongst Member States", not to be applied to the case at hand and that the mortgage interest was exclusively connected to the jurisdiction of the Member State levying tax on the positive income from the real estate concerned, i.e. Belgium[402]. Even more so if we consider the well-grounded, and often reiterated, principle according to which Treaty freedoms do

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[400] Court of Justice of the European Union, 16 October 2008, C-527/06, *Renneberg*.

[401] The Court also observed that, by way of the double taxation convention signed with Belgium, the Netherlands had retained the right to include items of income allocated to Belgium within the income of its residents for the purpose of ensuring progressivity of taxation, i.e. of determining the tax rate applicable on its residents' worldwide income, and that the consequence of this inclusion was that Dutch residents with a second house in Belgium could deduct the interest paid in relation to mortgaged loans taken out to finance said second house.

[402] See, on the point, amongst others, Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 71-72; Meussen, G.T.K., *Renneberg: ECJ unjustifiably expands Schumacker doctrine to losses from financing of personal dwelling*, in European Taxation, 2009, 4, 185.

not guarantee tax neutrality of any cross-border movement or relocation[403]. On the ground of this criticism, it has been stated that, in *Renneberg*, the Court came close to forcing the source Member State to apply worldwide taxation to non-residents.

Drawing a (partial) conclusion from all of the above, it could be argued, therefore, that, as numerous scholars have stated, that the "*Schumacker* doctrine" (i.e. the prevalence given to the taxpayer's personal situation and ability to pay) prevails over the other principles linked to the "parallel exercise of taxing powers" on the part of the Member States only as far as individuals and individual taxation are concerned. According to some authors, the difference of treatment between corporations and individuals could be found in the fact that, with regards to corporations, the Court looks at legal comparability, while, with regards to individuals, the Court had based its judgements on an analysis through the lens of ability-to-pay, in order to ensure that for individuals all elements influencing their personal ability to pay and economic capacity are always taken into account[404]. Needless to say that this hypothesis would essentially amount to stating that the Court has taken a "policy approach" with regards to the subject and comes very close to requiring Member States to grant "resident treatment" to non-residents.

Going back to the main point, in fact, it cannot be doubted that, even though the Court has found no ground in the Treaty freedoms to prevent the above-mentioned issues and recognises that it cannot prevent such "parallel exercise of tax jurisdiction" on the part of the Member States, in practical terms, the actual impediments to cross-border economic activities, as compared to comparable purely domestic activities taking place within one single jurisdiction, constitute a problem, especially for multinational groups of companies.

On the other hand, with regards to corporation tax, the Court has accepted that the Member State of residence and the Member State of source can limit their fiscal jurisdiction to profits accrued and losses suffered within their respective territories, with the consequent unavoidable "compartmentalisation" of positive and negative elements[405].

It did so, for example, in the *Lidl Belgium* judgement. The case[406] concerned the tax regime resulting from the double taxation convention between Germany and Luxembourg, by virtue of which foreign-source business income and business-related

[403] Court of Justice of the European Union, 12 July 2005, C-403/03, *Schempp*; Court of Justice of the European Union, 15 July 2004, C-365/02, *Lindfors*; Court of Justice of the European Union, 6 December 2007, C-298/05, *Columbus Container Services*; Court of Justice of the European Union, 28 February 2008, C-293/06, *Deutsche Shell*; Court of Justice of the European Union, 23 October 2008, C-157/07, *Krankenheim*.
[404] Terra, B.J.M., Wattel, P.J., *European tax law*, 73.
[405] The term is used in Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 69.
[406] Court of Justice of the European Union, 14 May 2008, C-414/06, *Lidl Belgium*.

losses and costs were eliminated from the German tax base, with the consequent non-deductibility of the losses incurred by a Luxembourg branch of a German company from that company's German profits, whereas the losses of a domestic German branch could be deducted from the domestic profits of the head company, since the profits of such domestic German branch could be taxed. The Court found there to be a discrimination, but considered the exclusion of foreign losses justified by the need to preserve the allocation of the power to impose taxes amongst Member States, acknowledging that the Court cannot, in absence of any measure adopted by the European Union legislature, compel Member States to selectively extend their fiscal jurisdiction to extraterritorial losses.

7. Territoriality cannot stand by itself: balanced allocation of taxing powers combined with the need to counter tax avoidance.

In more recent times, the Court of Justice's case law has started to show a considerably higher degree of attention for the fiscal interest of the Member States, acknowledging the legitimacy of national anti-avoidance provisions (in so far as they do not breach the proportionality requirement)[407].

It has already been highlighted that one of the purposes of the European Union is the establishment of legislative measures suitable to allow Member States to attain efficient and solid public finances, which sometimes clashes, in the field of tax law, with other European Union values and aims, such as the principle of non-discrimination and the fundamental Treaty freedoms. It should also be added that the protection of national public finances should not be interpreted in a "conservative" sense, as the Member States' will to resist the EU integration process, but rather as the necessary protection of fundamental mechanism governing the functioning of the Internal Market, that is to say the protection of the single national economic systems, thus avoiding a "fiscal crisis" for the Member State concerned and indirectly enhancing the efficiency and solidity of the Internal Market[408].

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[407] Sacchetto, C., *Member States tax sovereignty: between the principle of subsidiarity and the necessity of supranational coordination*, cited above, 807; Seer, R., *The jurisprudence of the European Court of Justice: limitation of the legal consequences?*, in European Taxation, 2006, 470. For an in-depth analysis of the problems connected to the prevention of tax avoidance in the European Union context, see also Ruiz Almendral, V., *Tax avoidance, the balanced allocation of taxing powers and the arm's length standard*, in Richelle, I., Schön, W., Traversa, E. (eds.), *Allocating taxing powers within the European Union*, Brussels, 2013, 131; Faulhaber, L.V., *Sovereignty, integration and tax avoidance in the European Union: striking the proper balance*, in Columbia Journal of Transnational Law, 2009, 48, 177.

[408] P. Boria, *L'anti-sovrano*, cited above, *passim*.

The attainment of such a purpose, based on the protection of the Member States's fiscal interest, entails, *inter alia*, the recognition, on the part of the Court of Justice, of the legitimacy of domestic measures aimed at countering tax evasion and tax avoidance in order to protect the effectiveness of the national tax systems, which, however, often pose more than a problem with concern to the compatibility of such measures with the fundamental freedoms and the principle of non-discrimination.

The Treaties do not mention the risk of tax evasion and/or tax avoidance as a possible limit to the general prevalence of the fundamental freedoms, with the only exception of Article 65 TFEU, which, with reference to the freedom of movement of capital, provides for the possibility for Member States to implement and enact national fiscal measures distinguishing between residents and non-residents and also on the ground of the country where the non-resident taxpayers resides or where the capital has been invested, or, more in general, other fiscal measures aimed at preventing breaches of national tax law.

At first, the Court of Justice was particularly reluctant in accepting the need to prevent tax avoidance as a mandatory requirement of public interest and, as such, as capable of justifying restrictions to Treaty freedoms[409]. Subsequently, the need to prevent tax abuse, as a species of the European Union law of a more general prohibition of abuse of rights, has been fully accepted as a possible justification ground for restrictive measure on the part of the Member States, in so far as the measures were proportionate, i.e. applied only to "wholly artificial arrangements"[410-411].

Later developments of the Court's case law have, however, shown a growing tendency towards acceptance of more restrictive measures. Legal scholars have argued that this change of approach is the result of the integration between two different justifications traditionally used by the Court of Justice, i.e. the need to prevent abuse (or tax avoidance) and the need to safeguard the coherence of the tax system (balanced

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[409] In the *Avoir fiscal* case (Court of Justice of the European Union, 28 January 1986, 270/83, *Commission v. French Republic*), the Judges rejected the French argument according to which extending the imputation credit system to French dividends paid to French branches of non-resident companies would create the risk of tax avoidance, since prevention of fiscal abuse was not amongst the justifiable reasons for restricting Treaty freedoms.

[410] The Court has, for example, stated that "*as regards the justification based on the risk of tax avoidance, suffice it to note that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent national tax legislation, from attracting tax benefits, but applied generally to all situations in which the majority of a group's subsidiaries are established, for whatever reason, outside the United Kingdom. However, the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance*" (Court of Justice of the European Union, 16 July 1998, C-264/96, *ICI v. Colmer*). The same approach has then been reiterated, for example, in the *Eurowings* and *Cadbury Schweppes* cases, where the Court ruled that Member States may not penalise the use of low-tax regimes in other jurisdictions if the economic activity conducted therein is genuine.

[411] The Commission has summarised the Court of Justice's case law on the point of abuse in the field of tax law in its Communication to the Council the European Parliament and the Economic and Social Committee of 10 December 2007 on the application of anti-abuse measures in the area of direct taxation, COM(2007)785.

allocation of taxing rights amongst Member States)[412]. Starting from the *ICI* judgement[413], the Court started accepting the principle of justifying a restriction with reference to the need to prevent the risk of tax avoidance, limiting this possibility only to cases where national legislation has the specific purpose of preventing wholly artificial arrangements set up to circumvent tax legislation.

The first examples of this new attitude may be found, for instance, in the *Van Hilten* judgement[414], which concerned the compatibility with European Union law of the Dutch inheritance tax regime, and, more specifically, of the definition of Dutch inheritance taxes on the basis of the nationality of the testator. In that case, the testator, of Dutch nationality, resided first in the Netherlands, then in Belgium and then in Switzerland, but her heirs were assessed to Dutch inheritance tax because of a Dutch provision under which a Dutch national who, having resided in the Netherlands, dies within ten years of ceasing to reside therein is deemed to have been resident in the Netherlands at the time of death. Such a regime posed serious questions as to its compatibility with European Union law and, more in particular, with free movement of capital.

The Court ruled that the Dutch provisions on the extension of inheritance taxes to former residents depending on whether or not they were Dutch nationals were compatible with EU law, arguing that the difference in treatment between nationals and non-nationals stemmed "*from the Member States' power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation*" and that the type of legislation at issue, extending inheritance tax jurisdiction on the base of a sort of fictitious residence of the testator, was "*justified by the concern to prevent a form of tax evasion whereby a national of a State, in contemplation of his death, transfers his residence to another State where the tax is lower*".

The above-mentioned *Marks & Spencer* judgement held a similar statement. In the latter judgement, in fact, the Court found the UK regime not providing relief for foreign losses of foreign subsidiaries not subject to UK tax jurisdiction as restrictive of the freedom of establishment, but also found that said regime could be justified in a combination of three different justifying grounds, one of which was the need to prevent

[412] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 476.
[413] Court of Justice of the European Union, 16 July 1998, C-264/96, *ICI*.
[414] Court of Justice of the European Union, 23 February 2006, C-513/03, *Heirs of M.E.A. van Hilten - van der Heijden v. Inspecetur van de Belastingdienst te Heerlen*.

tax avoidance[415] (the other ones were the risk of double dip and the need to ensure balanced allocation of taxing powers amongst Member States).

In some of its more recent decisions, the Court has even considered the possibility that a restrictive measure could be justified by the "*objective of combating tax havens*"[416], as possible overriding reason in the public interest to be weighted against the need to ensure the implementation of the fundamental freedoms and of the principle of non-discrimination.

The connection between territoriality (i.e. balanced allocation of taxing powers) and the need to prevent tax avoidance is even more evident in the already mentioned *Oy AA* judgement[417], where the Court basically stated that the preservation of a balanced allocation of taxing powers amongst Member States comprises in itself the purpose of curbing tax avoidance. The Judges found that "*the objectives of safeguarding the balanced allocation of the power to impose taxes between Member States and the prevention of tax avoidance are linked. Conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory is such as to undermine the right of the Member States to exercise their tax jurisdiction in relation to those activities and jeopardise a balanced allocation between Member States of the power to impose taxes*".

The concept of "wholly artificial arrangement" on which the Court of Justice has built a large part of its doctrine on the compatibility with European Union law of domestic anti-avoidance measures is particularly relevant for the purposes of the present research, since it provides indications as to the connecting criteria which the Court considers relevant in order to identify the circumstances on which to evaluate the effective integration of a taxpayer (especially a legal entity) within a Member State's legal order[418].

Furthermore, it should be incidentally recalled that the consistent application of said concept by the Court of Justice has largely influenced the EU legislature, which, in

[415] More specifically, the Court of Justice has stated that "*as regards, last, the third justification, relating to the risk of tax avoidance, it must be accepted that the possibility of transferring the losses incurred by a non-resident company to a resident company entails the risk that within a group of companies losses will be transferred to companies established in the Member States which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest. To exclude group relief for losses incurred by non-resident subsidiaries prevents such practices, which may be inspired by the realisation that the rates of taxation applied in the various Member States vary significantly*". (Court of Justice of the European Union, 13 December 2005, C-446/03, *Marks & Spencer*). It should be noted that, as highlighted by Terra and Wattel (Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 484), the Court did not even require the United Kingdom to asses whether cross-border relief would have been obtained by "wholly artificial arrangements", as it would have been necessary under the "*Cadbury Schweppes* doctrine".

[416] Court of Justice of the European Union, 1 April 2014, C-80/12, *Felixstowe Dock and Railway Company Ltd*.

[417] Court of Justice of the European Union, 18 July 2007, C-231/05, *Oy AA*.

[418] Dorigo, S., Mastellone, P., *L'evoluzione della nozione di residenza fiscale delle persone giuridiche nell'ambito del Progetto BEPS*, cited above, 66.

the recently adopted Anti-Tax Avoidance Directive[419], provided for a general anti-abuse rule according to which "*for the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes to obtain a tax advantage that defeates the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances*", specifying that "*an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality*".

In its *Cadbury-Schweppes* judgement[420], the Court has highlighted that, in order for a "wholly artificial arrangement" to exist, two elements should be verified, i.e. a subjective element (that is to say the will to obtain an undue fiscal advantage) and an objective element. With regard to the latter, the Judges, in their analysis, have implicitly described which should be the factual elements on which the effective and actual presence of a business entity within the Member States' territory should be evaluated, i.e., briefly said, an "organisational element", linked to the effective presence in the territory of objectively verifiable items such as personnel, real estate and machinery, and an "operative element", which means that the structure located in the Member State's territory should conduct a genuine and effective economic activity[421].

In order to better understand the relevance of the concept of wholly artificial arrangements" and its relevance for the purposes of EU law one should recall that the objective of the freedom of establishment, as clarified in *Cadbury Schweppes*, is to allow "*a national of a Member State to set up a secondary establishment in another Member State to carry on his activieis there and thus assist economic and social interpenetration within the Community in the sphere of activites as self-employed persons […]. To that end, freedom of establishment is intended to allow a Community national to participate, on a stable and continuing basis, in the economic life of a Member State other than his State of origin and to profit therefrom*". In light of this parameter, freedom of establishment cannot but only protect the "*actual pursuit of an*

[419] Council Directive 2016/1164/EU of 12 July 2016 "*laying down rules against tax avoidance practices that directly affect the functioning of the Internal Market*". For further details, see the next chapter of the research, at paragraph 5.

[420] Court of Justice of the European Union, 12 September 2006, C-196/04, *Cadbury Schweppes*. On a similar point, see also, more recently, Court of Justice of the European Union, 2 October 2013, C-282/12, *Itelcar*; Court of Justice of the European Union, 13 November 2014, C-112/14, *Commission v. United Kingdom*; Court of Justice of the European Union, 23 April 2008, C-201/05, *Test Claimants in the CFC and Dividend Group Litigation*, where the Court confirmed that CFC legislation can be justified under European Union law if targeted at wholly artificial arrangements intended to escape taxation, but it also specified that the compliance requirements provided for by CFC regimes cannot subject the taxpayer to undue administrative constraints or go beyond what is necessary to prevent abusive practices.

[421] It should also be noted that Advocate General Léger, in its Opinion on the *Cadbury Schweppes* case, had proposed a different three-part test for the evaluation of the effectiveness of the entity's presence in the Member State of establishment, that is to say a test based only on objective elements, i.e. the level of physical presence, the effectiveness of the activity performed by the entity and the economic value of the activity if compared to the parent company and the group as a whole. See Advocate General Léger Opinion on Case C-196/04, 2 May 2006.

economic activity through a fixed establishment in that State for an indefinite period", which "*presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there*"[422]. From this point of view, the extension of a "worldwide-like" liability to tax to non-resident subjects as well could be allowed, from the EU perspective, in case a non-residents were to be found as not significantly and effectively linked with the territory where it is established[423].

It should also be noted that this approach seems to be in line with the "*Schumacker* approach" as described above, which also essentially implies, *inter alia*, the acknowledgement of the relevance of the effective and actual level of "integration" of a certain subject in the host Member State for the purposes of the compatibility of the tax consequences of its behaviour with Treaty principles[424].

Going back to the main point, it should be recalled that, as well known, the *Cadbury-Schweppes* judgement concerned the compatibility of the United Kingdom Controlled Foreign Companies legislation. Since CFC rules imply that a country levies tax on a non-resident subject's foreign income (i.e. an income which, from an objective point of view, has no tie with the country levying the tax whatsoever), entailing taxation of foreign subsidiaries at the level of the state of the parent company on the ground of the principle of worldwide taxation (while excluding domestic subsidiaries from the application of this regime), the question was whether or not freedom of establishment prevents the Member State of residence of the parent company from levying taxes on a non-resident subsidiary as it were a non-resident permanent establishment (or branch) of a resident company. The Court found that such a regime is inherently discriminatory from an European Union point of view, since, by its own nature, it does not apply in purely domestic circumstances (since parent companies of domestic subsidiaries were not currently taxed on the profits of their subsidiaries), but only when a cross-border situation is involved.

The Judges, therefore, considered this sort of extensive application of a system of worldwide taxation to non-residents as, in principle, incompatible with EU law, with an approach that could seem, at least in part, as contrary to the rulings in *Van Hilten* and *Saint-Gobain* and, subsequently, in *Columbus Container Services*. The Court essentially found that taxation of foreign income constituted a restriction to a EU citizen's right of

[422] This position has been confirmed in other CJEU cases, such as Court of Justice of the European Union, 26 October 1999, C-294/97, *Eurowings*; Court of Justice of the European Union, 11 December 2003, C-364/01, *Barbier*; Court of Justice of the European Union, 21 February 2006, C-255/02, *Halifax*; Court of Justice of the European Union, 12 December 2002, C-324/00, *Lankhorst-Hohorst*; Court of Justice of the European Union, 13 March 2007, C-524/04, *Thin Cap Group Litigation*.

[423] Dorigo, S., *Residenza fiscale delle società e libertà di stabilimento nell'Unione Europea*, cited above, 301.

[424] Dorigo, S., *Residenza fiscale delle società e libertà di stabilimento nell'Unione Europea*, cited above, 297.

movement and establishment, with the "worldwide principle" implying a difference in treatment between domestic and foreign subsidiaries.

In its *Glaxo Wellcome* decision[425], the Court allowed Germany to invoke justifications based on both the need to safeguard of a balanced allocation of taxing powers amongst Member States and to combat tax avoidance and purely artificial arrangements in order to prevent resident companies purchasing shares of resident companies from non-resident companies from enjoying a deduction for the decrease of value of the shares due to the distribution of dividends, which would have been allowed in case the seller would have been a resident subject.

Perhaps the most interesting and emblematic judgement on this point, showing how the interpretation of the concept of "territoriality" has recently undergone yet another development, is, however, the decision rendered on the *Argenta* case[426].

From a first sight, the *Argenta* case would seem to only deal with the age-old question of whether or not Member States which, pursuant to a tax treat, relinquished their taxing powers over certain profits made outside their territories are obliged to extent the tax advantages provided for by their tax laws to assets and liabilities located outside their territory and which have given rise to such exempt profits[427]. However, the conclusions reached by the Court go beyond the boundaries of the above-mentioned question and have been considered as quite surprising by part of legal scholarship.

At issue were, in short, the Belgian provisions concerning the so-called "notional interest deduction", a tax-deductible allowance for corporate equity[428]. In brief, pursuant to that regime, in order to determine the amount of the notional interest deduction for each company several adjustments have to be made to the company's equity, one of which is that the net book value of the company's assets and liabilities invested in a permanent establishment in a country with which Belgium has entered into a double taxation convention is to be excluded from the company's equity. That is because, under Belgian tax treaties, all of which follow the OECD Model Convention, Belgium exempts the income attributed to foreign permanent establishment. It follows that Belgium did

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[425] Court of Justice of the European Union, 17 September 2009, C-182/08, *Glaxo Wellcome Gmbh*.
[426] Court of Justice of the European Union, 4 July 2013, C-350/11, *Argenta Spaarbank*.
[427] Neyt, R., Peeters, S., *Balanced allocation and coherence: some thoughts in light of Argenta and K*, in EC Tax Review, 2014, 2, 64. For a comment on the case at issue, see also De Broe, L., *The ECJ's judgement in Argenta: narrow interpretation of 'the preservation of the balanced allocation of taxing rights between Member States': a headache for designers of tax incentives in the Union*, in EC Tax Review, 2013, 3, 210.
[428] In force of that provision, each company is treated as if it had borrowed its equity at a certain yearly rate (equal to that of a ten-year Belgian government bond) and is therefore allowed to deduct a certain sum which is considered, for tax purposes, as the "fictional" interest paid on that loan. For a more detailed description of the regime at issue, its purposes and its problematic aspects, see De Broe, L., *The ECJ's Judgement in Argenta: narrow interpretation of the preservation of the balanced allocation of taxing rights between Member States. A headache for designers of tax incentives in the Union*, in EC Tax Review, 2013, 5, 210.

not intend to extend a tax benefit to the equity that its companies use in foreign permanent establishments and which generate profits that Belgium cannot tax according to the allocation of taxing powers designed in its double taxation conventions. In this context, Argenta, a Belgian savings bank, had a permanent establishment in the Netherlands. It was argued that the exclusion of the net book value of said permanent establishment from the computation of the notional interest deduction had a restrictive effect on the exercise of Argenta's freedom of establishment.

For the purposes of the present research, the most interesting part of the judgement deals with the justifications put forward by the Belgian government, according to which the exclusion of the net book value of the permanent establishment at issue was justified by the need to ensure the coherence of the Belgian tax system and the balanced allocation of taxing powers in the tax treaty between Belgium and the Netherlands, largely based on the principle of territoriality.

First of all, the Court denied the admissibility of the justification based on the coherence of the Belgian tax system, applying its traditional approach according to which, in order for that justification to be resorted to, there must be a direct link between the tax advantage and the tax levied and that, for this purpose, it is required that the tax advantage and the corresponding tax levy relate to the same tax and to the same taxpayer[429]. In *Argenta*, the Court found there not to be any direct link between the tax advantage which is computed on the company's equity and the tax assessed on the profits generated by these assets, stating that, in order to qualify for the notional interest deduction, it would suffice for the profit generated by the company to be theoretically taxable in Belgium, while it would not be required for the profit to be effectively subject to any tax.

Furthermore, and coming to the main point of interest of the judgement for the purposes of the present research, with regards to the justification based on the preservation of the balanced allocation of taxing powers, the Court stated that the fact that a Member State has agreed in a tax treaty with another Member State not to tax the profits of a permanent establishment located in the latter does not justify a systematic denial of a tax benefit to a company which is resident in the first Member State and has a permanent establishment in the other State.

[429] The requirement of a "direct link" in order for the justification based on the coherence of the domestic tax system to be allowed is clearly explained by the Court in *De Lasteyrie du Saillant* (Court of Justice of the European Union, 11 March 2004, C-09/02), in *Manninen* (Court of Justice of the European Union, 7 September 2004, C-319/02) and in *Krankenheim* (Court of Justice of the European Union, 23 October 2008, C-157/07).

According to the Court, the justification based on preserving the balanced allocation of taxing powers amongst Member States can only be relied upon only "*where the system in question is designed to prevent conduct capable of jeopardising the right of a Member State to exercise its powers of taxation in relation to activities carried out in its territory*"[430], thus limiting the possibility to resort to the justification based on territoriality to cases where the conduct of the taxpayers constitutes a case of base erosion and jeopardises the right of a Member State to assert its tax jurisdiction on profits generated in its territory (e.g., non-arm's length transactions, importation of losses from abroad under group relief regimes, exportation of profits to another country under group contribution rules, transfer of residence or appreciated assets…)[431-432].

A similar statement may also be found, for example, in the Court's decision on the *Timac Agro* case[433], where the Luxembourg Judges found that "*the objectives of safeguarding the balanced allocation of the power to impose taxes between Member States and the prevention of tax avoidance are linked*". The reason underlying the existence of such a link between the need to safeguard the allocation of taxing powers amongst Member State and the prevention of tax evasion and tax avoidance has been clarified by the Court, for example, in its *Van Caster* judgement[434], where it has been argued that "*the preservation of the balanced allocation between Member States of the power to tax is a legitimate objective recognised by the Court […], since it may be accepted as a justification for a restriction, in particular, where the system in question is designed to prevent conduct capable of jeopardising the right of a Member State to exercise its fiscal jurisdiction in relation to activities carried out in its territory*".

Such a reasoning, however, does not seem to be entirely convincing. In fact, the concept of "balanced allocation of taxing powers amongst Member States" cannot but refer, by its nature, to the "distribution" of fiscal jurisdiction between countries, i.e. to

[430] A similar statement was also made by the Court in its *Papillon* judgement, where the Luxembourg Judges seemed to draw a logical connection between the absence of the potential of tax avoidance and their subsequent refusal to accept the justification based on the need to ensure the balanced allocation of taxing powers amongst Member States. See Court of Justice of the European Union, 27 November 2008, C-418/07, *Société Papillon*. An entirely different principle was stated by the Court of Justice in the *Oy AA* judgement (case C-231/05), where the Judges found that even "*if the legislation at issue in the main proceedings is not specifically designed to exclude from the tax advantage it confers purely artificial arrangements, devoid of economic reality, created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory, such legislation may nevertheless be regarded as proportionate to the objectives pursued, taken as a whole*".

[431] De Broe, L., *The ECJ's judgement in Argenta: narrow interpretation of 'the preservation of the balanced allocation of taxing rights between Member States'. A headache for designers of tax incentives in the Union*, cited above, 210.

[432] The Court concluded that the tax advantage resulting from the notional interest deduction does not jeopardise Belgium's taxing rights to tax the profits generated by the activities carried out on its territory. The same applies to the Netherlands' right to tax income generated on its territory. Essentially, according to the Court, the notional interest deduction regime does not lead to any profit shifting from one Member State to another, especially since said deduction is computed as a fictional lump sum as a percentage of the company's equity, bearing no relation to the taxable profit generated by the company.

[433] Court of Justice of the European Union, 17 December 2015, C-388/14, *Timac Agro Deutschland GmbH*.

[434] Court of Justice of the European Union, 9 October 2014, C-326/12, *Van Caster*.

the (bilateral or multilateral) agreements reached by states in deciding which items of income each of them has the right to levy taxes upon. The risk of tax avoidance, on the other hand, does not threaten the distribution of taxing powers between countries *per se*, but, rather, the possibility for one country to levy taxes on certain items of income that were allocated to its fiscal jurisdiction. The link between "allocation of taxing powers" and "prevention of tax avoidance" does not, therefore, seem to be in any way conceptually direct and self-evident.

This is one of the reasons why part of the legal scholarship has argued that the requirement of manipulative behaviour by the taxpayer seems an unnecessary restriction of the justification based on balanced allocation. Even though the Judges seems to ignore this point in *Argenta*, in *Busley* and *Rewe*, as noted above, the Court had defined the purpose of the principle of territoriality as "*to establish in the application of EU law the need to take into account the limits of the Member States' powers of taxation*"[435]. As the justification based on territoriality is also incapable of justifying the application of restrictive measures enacted by the State of residence, it is not clear how can a Member State limit the scope of tax incentives which it grants to profits coming within the purview of its fiscal jurisdiction. In other words, it has been highlighted, on the point, that it would seem perfectly sound for a Member State to exclude certain assets from the scope of application of certain tax benefits granted to domestic companies if said Member State has also abandoned its taxing powers with regards to the profits deriving from the above-mentioned assets[436].

Scholars have, thus, wondered whether it should be assumed that the Court considers the justification based on the preservation of balanced allocation of taxing rights (i.e., the justification based on the principle of territoriality) not capable to justify *per se* legislation enacted by a Member State that reserves a tax benefit only to income that comes within the purview of that Member State's fiscal jurisdiction in case there is no evidence of any manipulative and/or abusive conduct put in place by the taxpayer. A positive answer to the question would imply a re-thinking, on the part of the Court, of its previous rulings in cases such as *Krankenheim* and *Lidl Belgium*, where the relevance of

[435] Where, for example, in *Timac*, the Court argued that "*the balanced allocation of the power to impose taxes has the objective of safeguarding the symmetry between the right to tax profits and the right to deduct losses*", with the justification based on balanced allocation of taxing powers entirely coinciding with the justification based on the concept of "fiscal coherence" as developed, *inter alia*, in *Bachmann*. Nonetheless, the Court, in the same *Timac* judgement, seemed to consider fiscal coherence as a different and separate concept, stating that "*such offsetting is, moreover, capable of ensuring fiscal coherence since that offsetting is the indissociable complement of the losses having previously been taken into account*". See Court of Justice of the European Union, 17 December 2015, C-388/14, *Timac Agro Deutschland GmbH*.

[436] De Broe, L., *The ECJ's judgement in Argenta: narrow interpretation of 'the preservation of the balanced allocation of taxing rights between Member States'. A headache for designers of tax incentives in the Union*, cited above, 211.

the "*logical symmetry*" between tax advantages and subjection to tax of the assets concerned was recognised for the purposes of justifying possible discriminatory measures[437].

The Court dwelled more on this last point by comparing the case at issue with one which was dealt with in the *Lidl Belgium* case, which, as highlighted above, concerned an apparently similar fact pattern and an apparently similar regime, but involved a different answer from the Court than the one provided in *Argenta*. It should be recalled that in that case the Court held that allowing a German company to deduct from its German profits the losses incurred in its permanent establishment located in Luxembourg, on whose profits Germany had no taxing rights, would pose a threat to the balanced allocation of taxing powers as agreed in the double taxation convention between Germany and Luxembourg because the company would be able to unilaterally choose where to have its losses deducted.

In its *Argenta* decision the Court has, therefore, traced a distinction between the two cases arguing that the *Lidl Belgium* judgement dealt with the conduct of a company that would have led to tax base erosion of the Member State of residence, while this risk was absent in the *Argenta* case, thus preventing Belgium from effectively using the balanced allocation justification. Some have seen this additional requirement of manipulative behaviour by the taxpayer as an unnecessary restriction to the scope of the justification as described by the Court in its previous case law and have argued that the distinction between *Lidl Belgium* and *Argenta* to be ill-founded.

8. The case of exit taxation as a testing ground for an "European principle of territoriality".

Residence-based taxation raises delicate questions of compatibility with European Union law where a EU citizen changes his/her/its taxing jurisdiction, thus exercising

[437] De Broe, L., *The ECJ's judgement in Argenta: narrow interpretation of 'the preservation of the balanced allocation of taxing rights between Member States'. A headache for designers of tax incentives in the Union*, cited above, 211. The Author also highlights that an *a contrario* interpretation of cases such as *Jobra* (case C-330/07) and *Tankreederei* (case C-287/10) would seem to contradict the position held by the Court in *Argenta*. In *Jobra*, Austria had refused an Austrian company a tax benefit related to an investment because the assets were used outside its territory and the Court rejected the argument stating that, as Austria had not relinquished its taxing powers on the assets at issue, the company was fully taxable in Austria on the income derived from such assets. On this point, it has been highlighted by legal doctrine that, since the Court seems to have resorted to the justification based on the need to preserve the balanced allocation of taxing powers as a means to avoid "loss trafficking", this justification would not significantly differ from that underlying a measure aimed at preventing the risk of tax avoidance; see, for instance, Cerioni, L., *The never-ending issue of cross-border loss compensation within the EU: reconciling balanced allocation of taxing rights and cross-border ability-to-pay*, in EC Tax Review, 2015, 5, 269; Eden, S., *The obstacles faced by the European Court of Justice in removing the 'obstacles' faced by the taxpayer: the difficult case of double taxation*, in British Tax Review, 2010, 6, 613.

his/her/its fundamental freedoms of movement: in doing so, a resident ceases to be resident and becomes, for the purposes of tax law, a non-resident.

According to the principle/criterion of territoriality, transfer of residence abroad determines the termination of unlimited tax liability in the emigration Member State and the beginning of a new unlimited tax liability in the country of immigration. Until 2016, when the so-called "Anti-Tax Avoidance Directive" has been issued[438], no effective form of coordination amongst states (and Member States) existed in terms of the criteria used by each country's tax system with regards to this circumstance and, therefore, it often happened that both the emigration state and the immigration state attempted to extend their taxing powers as much as they could, with consequent risks of double taxation and hindrance of freedom of movement for EU citizens.

This is one of the reasons why the topic of exit taxation shows how impossible it is to consider direct taxation as not central in the process of integration of the European Internal Market[439]: for a EU citizen to be able to transfer his/her/its residence to another Member State without being impaired or limited or without suffering excessively burdensome consequences is essential to the very implementation of the Treaty freedoms, which all revolve around the concept of cross-border movement.

Exit taxes are generally levied on the income and the capital gains which are deemed accrued when a taxpayer which was a resident of a certain country emigrates to another country, becoming a resident of the latter, thus preventing the possibility of the emigration state losing its taxing prerogatives when the taxpayer changes his/her/its taxing jurisdiction, exercising his/her/its fundamental freedoms[440]: it can be stated, therefore, that exit taxes are generally levied as a direct consequence of the exercise of fundamental freedoms[441]. In other words, exit taxation is amongst the endeavours undertaken by Member States to counter measures aimed at avoiding fiscal erosion of the tax base, which, of course, have to be tested against the fundamental freedoms provided for by Union law. Typically, the tax consequence of the application of an exit tax is a deemed alienation of the asset in case said assets are transferred abroad or in case corporate taxpayers transfer their place of management to another country or, finally, in case an individual taxpayer migrates to another country: exit taxes anticipate taxation

[438] On the point, see next chapter, paragraph 5.
[439] Carinci, A., *Il diritto comunitario alla prova delle exit taxes, tra limiti, prospettive e contraddizioni*, in European Tax Studies, 2009, 1.
[440] Some authors consider as falling within the category of "exit taxation" also all measures by way of which a taxpayer is still considered as "fiscally resident" even after having transferred its residence outside the territory of the country concerned (so-called "unlimited extended tax liability"), by way of a presumption attracting income produced after emigration within the scope of application of a state's tax jurisdiction. See Bizioli, G., *Aporie e contraddizioni della giurisprudenza europea in materia di exit taxation*, cited above, 381.
[441] Pistone, P., *The impact of Community law on tax treaties. Issues and solutions*, cited above, 188.

which would otherwise be due at the time of realisation, thus directly affecting the functioning of the Internal Market by being able to hinder the exercise of the taxpayer's right of establishment[442].

It is also true, however, that without exit taxes (or similar measures), taxpayers would enjoy the possibility to arbitrarily choose where their "hidden reserves" would be taxed, thus relocating companies to jurisdictions with the lowest tax rates in order to avoid the payment of higher amount of taxes and triggering base erosion phenomena. It has therefore been argued that exit taxation represents a tool used by states to adjust their fiscal models in coherence with the structure of national tax systems and to preserve the integrity of taxing jurisdiction in the emigration state. Such need could be, in theory, legitimate for the purposes of European Union law.

It should also be incidentally noted that the topic of exit taxation is not addressed by international tax law and conventions against double taxation. The OECD Model Convention does not take into account the problem either. Generally, however, conventional tax law allows the country of origin of the individual to levy taxes on the income accrued on its territory up until the moment of the transfer of the person's residence abroad.

After the first approach of the Court to the topic had excluded the compatibility of such measures with European Union law[443], in its subsequent case law, the Court of Justice has actually found that, in general terms, even though exit taxation restricts the exercise of the freedom of establishment on the part of European Union citizens, it may be justified by the need to safeguard the balanced allocation of taxing powers amongst the Member States. In doing so, the Court has also confirmed that Member States are free to choose the elements on which to levy tax within their own jurisdictions and that they are not compelled by any duty to align their tax laws with the tax laws of other Member States in order to ensure that transfer of companies are effectively neutral as far as taxation is concerned. Moreover, the case law of the Court of Justice generally distinguishes between emigration of legal entities and emigration of natural persons,

[442] For a more detailed analysis of the mechanisms and general functioning of exit taxation, see Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 506; Bizioli, G., *Aporie e contraddizioni della giurisprudenza europea in materia di exit taxation*, cited above. See also De Pietro, C., *Exit tax: territorialità e mobilità societaria*, in European Tax Studies, 2009, 1; Cipollina, S., *I confini giuridici del tempo presente. Il caso del diritto fiscale*, cited above, 199; Betten, R., *Income tax aspects of emigration and immigration of individuals*, Amsterdam, 1998, 10.

[443] Court of Justice of the European Union, 11 March 2004, C-9/02, *Hughes de Lasteyrie du Saillant*.

since legal entities derive their very existence from the provisions of national legal orders[444].

On the point, it should also be noted that if, pursuant to domestic law, a company is required to liquidate in order to relocate abroad, Member State could normally tax the unrealised capital gains upon dissolution, which would not constitute an exit tax in accordance with the *Daily mail* case law[445]. In that judgement, the Court of Justice found that Member States are not restricted by European Union law in deciding what should be the connecting factors which are relevant in order for a company to retain its legal status under their domestic law, being that it is left to the Member States to determine what is required for companies to come into existence as a legal person and how these companies continue their existence and maintain their legal personality[446-447].

It has been argued that this solution would be somewhat paradoxical, since it would entail that, on one hand, a Member State that requires liquidation in order for a company to relocate and imposes immediate taxation upon dissolution would not breach European Union law, whereas, on the other hand, a Member State which allows companies to freely transfer to another Member State without having to liquidate while imposing an exit tax would restrict freedom of establishment[448].

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[444] On the point, see especially Court of Justice of the European Union, 27 September 1988, C-81/87, *Daily Mail*; Court of Justice of the European Union, 5 November 2002, C-208/00, *Überseering*; Court of Justice of the European Union, 16 December 2008, C-210/06, *Cartesio*.

[445] Court of Justice of the European Union, 27 September 1988, C-81/87, *Daily Mail*.

[446] With the only limit posed by the *Cartesio* judgement (Court of Justice of the European Union, 16 December 2008, C-210/06), where the Court of Justice ruled that, if the Member States to which the seat of the company is transferred accepts the immigration of such a company and allows it to "transform" into a company subject to its domestic corporate law without the need of necessarily winding up (so-called "inbound conversion"), the Member State of origin of that company may not prohibit the migration and make the relocation conditional upon the liquidation of the company. This principle has been, more recently, confirmed by the Court in its decision on the *Vale* case as well (Court of Justice of the European Union, 12 July 2012, C-378/10).

[447] Member States' company law on the point is generally based on either the "incorporation principle" (according to which the company is governed by the law of the state where the company's registered office or statutory seat is located) or the "real seat principle" (according to which a company can retain legal personality under the law of a certain state only if the relevant substantive connecting factors with that state's legal order are and continue to be located in that state's territory), although it may also provide for a sort of combination of both. In general terms, in the European Union's context, Member States resort more frequently to the "incorporation principle", even though the "real seat principle" has been adopted, for example, by Germany, Spain and Portugal.

[448] Especially since, pursuant to Article 54 TFEU, "*companies […] formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business*" within the European Union "*shall […] be treated in the same way as natural persons who are nationals of Member States*" for the purposes of the freedom of establishment. However, the Court's approach as mentioned above had been, then, confirmed by the Court of Justice of the European Union in the *Commission v. Portugal* judgement as well (6 September 2012, C-38/10), where the Court concluded that immediate taxation upon the cessation of the economic activity of a permanent establishment cannot be considered as a restriction to the freedom of establishment since there is no discrimination, given that cessations of activities of permanent establishments in domestic situations are treated in the same way. On the point, see Sendetska, O., *ECJ case law on corporate exit taxation: from National Grid Induc to DMC: what is the current state of law*, in EC Tax Review, 2014, 4, 231; Van der Broek, H., Meussen, G., *National Grid Indus case: re-thinking exit taxation*, in European Taxation, 2012, 4, 193; Wattel, P.J., *Exit taxation in the EU/EEA before and after National Grid Indus*, in Tax Notes International, 2012, 5, 371; Vilagi, R., *Exit taxes on various types of corporate reorganisations in light of EU law*, in European Taxation, 2012, 7, 50; Potgens, F.P.G., van Os, P., Duran, P.H., et al., *The compatibility of exit tax legislation applicable to corporate taxpayers in France, Germany, Italy, the Netherlands, Portugal, Spain and the United Kingdom with the EU freedom of establishment*, in Intertax, 2016, 1, 41.

Having established all of the above, it should also be noted that, for several years now, the main discussions on the point of exit taxation have focused on more practical issues, revolving around the need to ensure that exit taxation measures, though generally allowed by the Court of Justice, do not fail the proportionality test, i.e. do not go beyond what is necessary to attain their purposes and do not impose a disproportionate burden on taxpayers[449].

For the purposes of the present research, the Court's case law on exit taxation is relevant essentially because of the interpretation of the concept of "territoriality" thereby suggested by the Judges, and because of the consequent idea of a "proto-design" of the allocation of taxing powers amongst Member States. It is also one of the cases in which it is easier to examine the interaction between territorial tax systems and the need to counter tax avoidance as interpreted by the Court of Justice.

Starting from the *N. v. Inspecteur* case[450], we should recall that the Court, in accepting, in general terms, the legitimacy of exit taxation, has stated, on the point of territoriality, that "*preserving the allocation of the power to tax between Member States is a legitimate objective recognised by the Court of Justice*" and, therefore, with regards to the regime at issue, "*it is in accordance with the principle of fiscal territoriality, connected with a temporal component, namely residence within the territory during the period in which the taxable profit arises, that the national provisions in question provide for the charging of tax on increases in value recorded in the Netherland, the amount of which has been determined at the time the taxpayer concerned emigrated and payment of which has been suspended until the actual disposal of the securities*"[451].

It is clear that, in the *N.* case, the Court's reference to an interpretation of territoriality as a principle, i.e. the principle according to which countries have the right to tax items of income which are charactarised by a (either subjective or objective) connection with their territory.

Therefore, the Court of Justice has noted that the Dutch legislation at issue is aimed at ensuring a proper allocation of tax jurisdiction amongst Member States because

[449] For an analysis of the "open questions" still left on the point of exit taxation, see, amongst others, Sendetska, O., *ECJ case law on corporate exit taxation: from National Grid Indus to DMC: what is the current state of law*, cited above, 231, and the authors cited therein.

[450] Court of Justice of the European Union, 7 September 2006, C-470/04, *N. v. Inspecteur*. The case concerned a Dutch resident emigrating to the United Kingdom, who was issued a conservatory assessment for the unrealised capital gains in his shares in two companies located in the Antilles and who was required to provide security for payment upon realisation.

[451] It has been suggested that the approach taken in *N.* was to a large extent influenced by the evolution of the Court's case law impressed by the *Marks & Spencer* judgement examined above, where, for the first time, the Luxembourg Judges had acknowledged that the protection of the allocation of taxing powers amongst Member States constitutes a legitimate justifying ground for national tax measures limiting the scope of application of consolidated group relief only to subjects residing within national territory. Bizioli, G., *Aporie e contraddizioni della giurisprudenza europea in material di exit taxation*, cited above, 384.

Member States retain the power to establish the criteria of the connection between the tax object and their territories[452], and also because it seemed "reasonable" for the exercise of such power to be inspired by international tax law. The ruling followed the opinion rendered by AG Kokott on the *N.* case[453], where it was observed that, even though a precise definition of the principle of territoriality does not currently exist, it would appear reasonable to conclude that the existence of a link between the tax object and the national territory is a sufficient condition for the exercise of taxing powers on the part of Member States.

This justification finds its ground in the need to preserve the Member States' fiscal interest, i.e. in the constant balancing between the interests constituting the bedrock of the Internal Market and national fiscal interest. In the Court's case, one of the expressions of the constant search for this balance is the role granted to the principle of tax territoriality, which is here interpreted by the Luxembourg Judges as a criterion for the description of a connection between the tax object and the territory of the Member States and as a criterion for the allocation of tax bases and tax revenues amongst Member States[454].

From this perspective, the *N.* judgement constitutes an example of the "overall approach" of the Court of Justice or, for the purposes of our research, an example of the so-called "always somewhere approach". Forcing the Member State of origin or, alternatively, the Member State of destination to take into account the decreases of value suffered by the goods after the transfer of residence, in fact, implies acknowledging that the lack of elimination of juridical double taxation constitutes a restriction of fundamental Treaty freedoms, but also, to a certain extent, implies denying the relevance of the allocation of taxing powers as a justifying ground[455].

A different solution can be found in what should be defined as the Court's landmark decision in the field of the fiscal consequences of cross-border company

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[452] The existence of such a discretionary power on the part of the Member States is consistently confirmed by the Court of Justice. See, for example, Court of Justice of the European Union, 22 December 2010, C-287/10, *Tankreederei*, and the decisions cited therein.

[453] Opinion of AG Kokott on Case C-470/04, *N. v. Inspecteur*.

[454] Bizioli, G., *Aporie e contraddizioni della giurisprudenza europea in materia di exit taxation*, cited above, 386; De Man, F., Albin, T., *Contradicting views of exit taxes under OECD MC and TFEU: are exit taxes still allowed in Europe?*, in Intertax, 2011, 617; Seiler, M., *Exit taxation arising from a deemed disposal of shares*, in Bulletin for International Fiscal Documentation, 2013, 583.

[455] Bizioli, G., *Aporie e contraddizioni della giurisprudenza europea in materia di exit taxation*, cited above, 391, which highlights that the proportionality judgement of the Court clashes with the general interest previously defined as preeminent. The Author, in fact, notes the contradiction between stating that the immediate taxation of latent capital gains at the moment of the transfer of residence realises a balanced allocation of taxing powers amongst Member States and, on the other hand, stating that the tax base of exit taxes should conform to the decreases of value occurred after the transfer of the taxpayer's residence abroad, i.e. outside national borders. See also Wattel, P.J., *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power: what is the difference?*, cited above, 155: according to the Author, "*it is not the Court's competence to allocate losses and gains, especially not asymmetrically, as these are, in the Court's own words, two sides of the same coin*".

migration, and the consequences for the allocation of taxing powers amongst Member States, which was rendered in the *National Grid Indus* case[456]. In this judgement, in fact, notwithstanding the fact that the decision on comparableness and on the justifications for the restrictive measure follows the same criteria used in *N.*, the Luxembourg Judges set out certain limits to the fiscal sovereignty of the Member States in the field of corporate exit taxation and also acknowledged the existence of a difference between the circumstances of individuals and legal persons as far as the compatibility of exit taxation with EU law is concerned[457].

With this decision, the Court, even though it held that applying immediate capital gains taxation at the moment of the transfer of the place of management and control constituted a restriction on the freedom of establishment (since such a transfer, if it were to be put in place in a purely domestic context, would not have triggered any specific tax measure), nonetheless stated that the objective to ensure a balanced allocation of taxing powers between Member States may, in principle, justify the taxation of the gains accrued at the time of migration, even though immediate taxation of such gains at the time of the transfer constitutes an excessive and disproportionate measure. The Court admittedly reached this conclusion referring essentially to the implication of the principle of fiscal territoriality interpreted as described above, arguing that the link between the company and the territory of the Member State constitutes a legitimate criterion for the allocation of taxing powers and that, therefore, taxing powers may be exercised on the value of the capital gains accrued up until the moment of the transfer of the company's place of effective management.

This conclusion is then confirmed in the final stage of the Court's "rule of reason test", i.e. the analysis of the proportionality of the measure. In contrast with the conclusions reached in *N.*, in fact, the Judges rule that "*establishing the amount of tax at the time of the transfer of a company's place of effective management complies with the principle of proportionality, having regard to the objective of the national legislation at issue in the main proceedings, namely to subject to tax in the Member State of origin the capital gains which arose within the ambit of that State's power of taxation*" and that "*it is proportionate for that Member State, for the purpose of safeguarding the exercise of its powers of taxation, to determine the tax due on the unrealised capital gains that have arisen in its territory at the time when its power of*

[456] Court of Justice of the European Union, 29 September 2011, C-371/10, *National Grid Indus BV*. The case dealt with the transfer of the place of effective management of a Dutch company from the Netherlands to the United Kingdom, which triggered Dutch taxation on the company's unrealised currency gains.

[457] On this distinction, see Dourado, A.P., Pistone, P., *Looking beyond Cartesio: reconciliatory interpretation as a tool to remove tax obstacles on the exercise of the primary right of establishment by companies and other legal entities*, in Intertax, 2009, 342.

taxation in respect of the company in question ceases to exist, in the present case the time of the transfer of the company's place of effective management to another Member State"[458].

In light of the fiscal principle of territoriality, therefore, the Court ruled that the Netherlands was not obliged, in the implementation of its exit taxes, to take into account decreases in value of the transferred assets that took place after the transfer, i.e. when the tax object has lost all of its connection with the taxing Member State. And that because, briefly said, such assets, after their transfer, produce profit in the Member State of destination and depreciate in the Member State of destination, which implies, always as a consequence of the "territorial symmetry" to which tax systems should be inspired, that it is also for the Member State of destination to tax the profits, and grant a deduction for the losses, arising from such assets after their transfer.

This conclusion essentially amounts to reaffirming that Member States are free to choose what elements to tax within their own fiscal jurisdictions and that, since the capital gains arose within the ambit of the power of taxation of the departure State, said State has the right to its fair share of the capital gains accrued up until the time of transfer. Furthermore, Member States are not obliged to bring their tax regulations in line with those of other States so as to achieve complete and utter neutrality of transfers for companies[459]. As consistently noted by scholars and by the Court itself, a case of disparity of tax rules in two Member States, from which a prejudicial effect arises for taxpayers, is different than that of a restriction in one Member State which hinders or makes it more difficult to migrate to another country or discriminates against all taxpayers who relocate abroad[460].

The Court has confirmed the above-mentioned principles in all of its subsequent decisions on exit taxation, having stated, also in recent times, that "*according to the fiscal principle of territoriality, a Member State is entitled, in the case of a transfer of assets to a permanent establishment located within another Member State, to impose tax, at the time of the transfer, on the capital gains generated on its territory prior to that transfer*" and that "*such a measure is intended to prevent situations capable of jeopardising the right of the Member State of origin to exercise its powers of taxation in relation to activities carried on in its territory*"[461].

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[458] A similar statement can also be found in Court of Justice of the European Union, 25 April 2013, C-64/11, *Commission v. Spain*.

[459] Court of Justice of the European Union, 29 September 2011, C-371/10, *National Grid Indus BV*, par. 45-48.

[460] O'Shea, T., *European tax controversies: a British-Dutch Debate: back to basics and is the ECJ consistent?*, in World Tax Journal, 2013, 106.

[461] Court of Justice of the European Union, 21 May 2015, C-657/13, *Verder LabTec*, where the Court found that immediate taxation of he unrealised capital gains related to assets such as patents, trademarks and models transferred by a German partnership to its permanent establishment located in the Netherlands constituted a restriction of freedom of establishment because, in a purely domestic situation, a similar transfer would not determine the taxation of any unrealised capital gain.

The Court consistently upheld this reasoning in its following decisions concerning exit taxation and, specifically, with regards to infringement procedures brought by the European Commission against Portugal[462], The Netherlands[463], Spain[464] and Denmark[465]. Furthermore, the *DMC* judgement by the Court[466] extended the reasoning to cross-border corporate reorganisations as well: the Court, quoting from its *National Grid Indus* decision, ruled that the Member State losing its connection between the company's goods at issue and its territory can legitimately levy tax on latent capital gains realised after the operation[467]. Furthermore, the *DMC* decision clarified that Member States entitled to tax capital gains generated when the assets in question were on their territory have the power to make provision for a chargeable event other than the actual realisation of those gains, in order to ensure that the assets at issue are taxed.

Therefore, as the Court's case law stands at the moment, exit taxes are deemed compatible with the freedom of establishment, as they pursue a legitimate objective in the public interest[468], and Member States are allowed to introduce exit taxes on unrealised gains accrued during the time in which an individual or a company have been residing in their territory[469]. In other words, the Court of Justice has stressed the need to guarantee full freedom of movement within the Internal Market, though also acknowledging the need to protect the effectiveness of the exercise of the taxing powers of the Member State of emigration on the accrued capital gains.

With regard to the main topic of our study, the principle of territoriality as developed by the Court's case law on exit taxation, unlike the "principle" which would derive from the international tax law practice, does not exhaust its effects in the description of the factual elements which are territorially relevant (essentially, residence and source), by virtue of which countries may exercise their taxing powers, but it expands to encompass a "temporal component" that is traditionally unknown to the "classic" elaboration of the concept of territoriality.

[462] Court of Justice of the European Union, 06 September 2012, C-38/10, *Commission v. Portugal*.
[463] Court of Justice of the European Union, 31 January 2013, C-301/11, *Commission v. The Netherlands*.
[464] Court of Justice of the European Union, 25 April 2013, C-64/11, *Commission v. Spain*.
[465] Court of Justice of the European Union, 18 July 2013, C-261/11, *Commission v. Denmark*.
[466] Court of Justice of the European Union, 23 January 2014, C-164/12, *DMC*.
[467] For an overall analysis of the mentioned case law, see Von Brocke, K, Müller S, *Exit taxes: the Commission versus Denmark case analysed against the background of the fundamental conflict in the EU: territorial taxes and an Internal Market without barriers*, in EC Tax Review, 2013, 6, 299; Sendetska, O., *ECJ case law on corporate exit taxation: from National Grid Indus to DMC: what is the current state of law?*, cited above, 230.
[468] See also Court of Justice of the European Union, 18 July 2013, C-261/11, *Commission v. Denmark*; Court of Justice of the European Union, 23 January 2014, C-164/12, *DMC*; Court of Justice of the European Union, 16 April 2015, C-591/13, *Commission v. Germany*.
[469] Also, Member States are free to asses the corporate exit tax definitively on the date of the transfer and they do not have to take into account any future losses that may or may not occur after the migration of a company or of some of their assets, since they do not have any connection with the company or the asset by reason of a limitation of their jurisdiction.

In application of such a new dimension to the topic of the allocation of taxing powers between Member States - which determines not only which of the countries involved gets to tax the income concerned, but also the "intensity" of the tax burden countries may impose, which is directly proportional to the insentity of the temporal component - tax sovereignty and tax jurisdiction, therefore, end up being split - or, better said, shared - between the two Member States involved in the transfer of residence on the ground of an entirely new dimension of territoriality, which refers to a territory which coincides with the Internal Market[470].

In other words, intra-EU transfers of residence (either by individuals or corporations) cannot be conceived and analysed from a merely national perspective and as the sum of two distinct national operations (the loss of the former residence combined with the acquisition of a new residence), but as a single cross-border operation[471], with the need to ensure the coordination between the national systems involved so as to avoid double taxation as much as double non-taxation, to enact a balanced allocation between the two Member States involved and to prevent undue limitations and obstacles to the achievement and implementation of an effectively integrated Internal Market. In other words, the purpose is to achieve neutrality (or the highest possible degree of neutrality). On the point, as we will see in the following chapter of the research, some steps have been taken with the recent adoption of the so-called "Anti-Tax Avoidance Directive"[472].

9. Concluding remarks: overall analysis of the Court of Justice's case law on the tax treatment of non-residents and open questions for a hypothetical effective integration of the Internal Market.

As it has probably already been inferred from all of the above, it certainly is considerably difficult to "systematise" the orientations of the Court of Justice's case law in the field of direct taxation, with specific regard to the problem of the allocation of taxing powers amongst Member States and to the related topic of the fiscal treatment of non-residents in the context of income taxation. The analysis of the case law described above shows the way the Court's approach to territoriality has changed through the years.

[470] More on the point of exit taxation will be seen in the next chapter of the research, when talking about the provisions of the new Anti-Tax Avoidance Directive, at paragraph 5.
[471] Carinci, A., *Il diritto comunitario alla prova delle exit taxes, tra limiti, prospettive e contraddizioni*, cited above; Greggi, M., *Riflessi fiscali della mobilità all'interno della UE: per un nuovo Nomos europeo*, in European Tax Studies, 2009, 1.
[472] See Chapter III, at paragraph 5.

The first thing that should be highlighted concerns the interpretation of the meaning of "territoriality". The Court accepts the concept/principle/criterion of territoriality as, at least theoretically, relevant for the purposes of the allocation of taxing powers amongst Member States in the context of the Internal Market. In doing so, as shown above, it refers to the principle of territoriality "as it is used in international (tax) law". However, the current understanding of the term in international tax law is, or should be, different from the meaning given to "territoriality" by the Court[473], especially in light of the reasons that have been analysed in the previous chapter of the research.

In fact, it is highly doubtful that a general principle of territoriality might actually be inferred from the current state of international (tax) law, given that, *rebus sic stantibus*, such a principle does not appear to be enshrined neither in a general principle of international law nor in a international customary rule and it is not in any way recognised as binding by any country in the international scenario. This assumption cannot but raise the question of which meaning of territoriality the Court makes reference to when expressly mentioning the "principle of territoriality as enshrined in international law". In the international law context, territoriality is considered as simply a criterion on the ground of which countries may shape the extension of their fiscal jurisdictions, a mere parameter for the distribution of tax bases and fiscal revenues amongst states, whereas, as it has been highlighted above, in the European Union framework, territoriality has acquired, through the words of the Court of Justice, the considerably different meaning of "balanced allocation of taxing powers" amongst Member States.

This is one of the reasons why there is a certain degree of uncertainty concerning the meaning and the relevance of "territoriality" in the Court of Justice jurisprudence on direct taxation, and especially on the role that territoriality might play in the definition of how far Member States can go when defining the extension of their taxing powers with specific regard to non-residents. Starting from *Futura*, where the Luxembourg Judges had used the concept of territoriality almost as a proxy for the fundamental difference between taxation by the state of residence and taxation by the source state, with a considerable justificatory potential for different treatment of residents and non-residents, to *Marks & Spencer*, *Oy AA*, *Busley* or *National Grid*, where the Court translated the principle of territoriality into one of the justifications developed by European Union case law as possible ground on which to base discriminatory or restrictive measures. In other

[473] According to Marres, the Court considers taxation of residents on their worldwide income "*as a manifestation of territoriality*", even though "*tax lawyers would call that worldwide taxation, as opposed to territorial taxation*"; see Marres, O., *The principle of territoriality and cross-border loss compensation*, cited above, 125.

words, the fiscal territoriality principle is now treated as a justification for discrimination, instead of as the description of a set of rules that escapes the scope of application of European Union law[474]. In light of the somehow "vagary" approach of the Court of Justice on the point, it has been argued that the Luxembourg Judges have not, as of today, applied the principle of territoriality in a consistent manner, but as a concept suiting the result that the Court seeks to attain in each different specific case, e.g. sacrificing it to the "always somewhere doctrine" in the case of final losses in *Marks & Spencer* or to the "ability-to-pay principle" in *Schumacker*[475].

An inaccurate understanding of the meaning of "territoriality" might, however, lead to disconcerting results, especially in light of the unavoidable interaction between tax systems that is inherent to a globalised economy, where cross-border transactions are always in order, and even more so in the context of an Internal Market such as the one pursued by the Treaties. This interaction depends on many different factors that may also go beyond the mere scope of application of national tax provisions, e.g. specific forms of taxation, the existence and interpretation of bilateral tax treaties, the concrete methods employed to alleviate or prevent international double taxation, etc.[476]

It has been already noted that the Court of Justice, in decisions such as *Rewe* and *Busley*, has defined the "*purpose of the principle of territoriality*" as "*to establish, in the application of Community law, the need to take into account the limits on the Member States' power of taxation*", thus referring to an interpretation of the states' taxing powers as inherently limited, which is substantially different from which can be inferred from the analysis of the principles governing international (tax) law, if one is to disregard the merely contingent and "practical" asset arising from the network of tax treaties signed by countries.

Some have interpreted this definition of "territoriality" as the declaration of a preference of the Court of Justice for strictly territorial tax systems, arguing that such a statement would entail the recognition that non-residents' income which is not sourced within the territory of a Member States should not be taken into account by that Member State for tax purposes, irrespective of the place of residence of the taxpayer. We will come back on the point in the following pages and also in the next chapter of the research. Suffice it to say now that such an argument does not seem to be entirely convincing, especially if we consider that, in judgements such as *Futura* and *Marks &*

[474] Wattel, P.J., *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power: what is the difference?*, cited above, 149.
[475] Wattel, P.J., *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power: what is the difference?*, cited above, 150.
[476] Garcia Prats, F.A., *EC law and direct taxation: towards a coherent system of taxation?*, cited above, 5.

Spencer, seems to have embraced a vision based on an interpretation of "territoriality as a principle" (and not as a criterion), accepting that Member States can tax their residents on a worldwide basis and their non-residents only on the income having its source within their territory. Embracing this view of territoriality would mean that, according to the Court, a difference in fiscal treatment between residents and non-residents can be accepted for the purposes of European Union law.

The evolution of the Court of Justice's case law has, however, shown a progressive, and almost total, abandonment of the idea, stated for the first time in *Schumacker*, that non-residents should, unless under exceptional circumstances, never be comparable to residents in the field of direct taxation; on the contrary, the role of such an idea has been reduced to a limited area, which is that of personal and family circumstances of individuals[477]. On the other hand, in other areas, such as company taxation, the main reasoning applied by the Court is different, i.e. that residents and non-residents are comparable for EU law purposes in the field of tax law.

In the Court's view, asserting the relevance of the concept of "territoriality" does not directly imply the need for a country to exercise its taxing powers only on domestic-source income, i.e. on income originating within its territory. On the contrary, said concept (or "principle", as the Court defines it) would have to support the choices made by each Member State in establishing connection criteria which are territorially relevant in modulating the extension of state fiscal sovereignty or, better said, fiscal jurisdiction, either from a "subjectively" or an "objectively" territorial perspective. This interpretation of "territoriality" would, therefore, seem to radically prevent any interpretation of the Court of Justice's case law as an indication of a theoretical preference of the European Union legal order for a model based on capital import neutrality and on a tax model based on strict and "pure" territoriality (i.e. levying taxes only on domestic-source income). Even more so if we consider that, as we will see in the following chapter, the hypothetical preference of the EU legal order for such a model seems to be contradicted by the considerable predominance, in the provisions of the few Directives on (some aspects of) direct taxation, of fiscal models based on a substantially recessive role of the source state and on the affirmation of the exclusivity of the taxing powers of the country of residence.

Which brings us to the evolution of the concept of "territoriality" in the Court of Justice's jurisprudence.

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[477] Cordewener, A., *Personal income taxation of non-residents and the increasing impact of the EC Treaty freedoms*, cited above, 71.

At first, as it has been highlighted above, the Court's approach to the topic was essentially "radical": if a national tax system adheres and is inspired to the principle of territoriality - meaning the implementation of a worldwide system for residents and a system of taxation at source for non-residents - then the relevant national measures cannot be considered as discriminatory or otherwise in breach of European Union law, which implies that the "rule of reason test" of the Court stopped at its "first step", with no need for any analysis concerning possible justifications for the measure at issue. This is the conclusions reached by the Court, for instance, in its decision on the *Futura* case. The same result is achieved also by referring to the general statement according to which the positions of residents and non-residents are not generally comparable for the purposes of direct taxation, which, once again, precludes any possibility for a tax measure treating the two categories in a different way to be considered as in breach of a fundamental Treaty freedom or of the principle of non-discrimination.

This approach is essentially in line with the so-called "parallel exercise of taxing powers" doctrine, inaugurated by the Court in decisions such as *Schempp*, *Kerckhaert Morres*, *Damseaux* and *Block*, which indeed takes a step further: Member States are free to shape their direct tax systems as they see fit, provided they do not discriminate in an unjustifiable manner, especially against non-residents, and, therefore, they are free to decide to tax residents on their worldwide income and non-residents only on the income generated within their territory, or even to tax both residents and non-residents on a strictly territorial basis; and, according to this approach, Member States are also free to decide which items of income not to tax.

Subsequently, however, the tables have considerably turned, with the Court of Justice stepping away from its "*Futura* doctrine" and taking into consideration elements, such as ability-to-pay, that lead it quite far from the "parallel exercise doctrine" as well, even though such an approach has never been denied or refuted by the Court of Justice as of today.

In judgements such as *Marks & Spencer*, territoriality is "demoted" to being one the possible justifications (i.e. legitimate purposes of primary interest) that can legitimise Member States' discriminatory and/or restrictive tax measures. Territoriality becomes, in the words of the Court of Justice, what is currently known as "balanced allocation of taxing powers". If, as we have seen earlier, at first compliance with the principle of territoriality in the sense described above excluded the possibility for a certain fiscal measures to be interpreted as breaching European Union law, now the analysis "through the territoriality lens" is shifted from the "first step of the rule of reason test" to the

"second step" of said test. Territoriality is thus treated as a possible justification in light of the Member State's aim of attaining a legitimate objective in the public interest.

In other words, the Court has recognised the relevance and value of the Member States' fiscal interests and it did so, *inter alia*, through the elaboration of justifying reasons, specifically created by the Court for the field of taxation, that could legitimize national measures somehow discriminating against non-residents or restricting the possibility for EU citizens to exercise their Treaty freedoms[478].

In applying its "rule of reason test"[479], the Court has acknowledged the possibility to justify restrictive fiscal measures on the part of the Member States on the ground of the need to protect fiscal coherence, which essentially amounts to the need to match, within the same jurisdiction, negative elements of income (i.e., tax base reductions) and positive elements of income (i.e., the corresponding tax base increases), such as losses and corresponding profits, deductions and corresponding benefits, income and the expenses incurred in earning it, and so on. The need to ensure the coherence of the tax system was first accepted as justification for restrictive measures in the *Bachmann* judgement, but was later consistently rejected, only to be considered again as valid ground for justifying fiscal restrictions in other judgements, such as *N.* and *Krankenheim*. The Court has later specified that Member States may not justify a restrictive measure on the ground of the need to ensure coherence of its tax system from an internal perspective is such coherence is already preserved at an international level by way of a double taxation convention[480].

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[478] Isenbaert, M., *The contemporary meaning of 'sovereignty' in the supranational context of the EC as applied to the income tax case law of the ECJ*, in EC Tax Review, 2009, 6, 273.

[479] The Court summarised the common features of the "rule of reason test" in its *Gebhard* judgement (30 November 1995, C-55/94, *Reinhard Gebhard v. Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*), where it stated that "*national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: 1) they must be applied in a non-discriminatory manner; 2) they must be justified by imperative requirements in the general interest; 3) they must be suitable for securing the attainment of the objective which they pursue; and 4) they must not go beyond what is necessary in order to attain it*". On the point, it has been shown that in more recent case law in direct tax matters the Court has "converted" to a three-step "rule of reason test", having realised that having to judge justifications for certain tax systems would entail evaluations of a political nature. Therefore, the core of the test in direct tax matters is as follows: 1) does the Member State concerned distinguish between a purely national (domestic) situation and a comparable cross-border situation in such a way as to hinder the exercise of free movement? 2) in case it does, is such a measure justified by a legitimate aim? 3) in case it is, does the hindering effect of the measure go beyond what is necessary to attain that legitimate aim? On the point, see Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 45. For a criticism of the application of the "rule of reason test" to tax cases concerning discrimination, see Wattel, P.J., *Red herrings in direct tax cases before the ECJ*, cited above, 83, where the Author states that, on the basis of the Court's ruling in the *Gebhard* case (case C-55/94), only a justification explicitly mentioned in the Treaties, such as public safety or public health, could allow the Court not to prohibit discriminatory national measures and that "*the case law holding that measures with distinctions can only be justifies under explicit Treaty exceptions is incompatible with the case law holding that indirectly discriminatory tax measures may be justified under unwritten notions like the necessity to maintain the coherence of the tax system, the necessity to curb abuse and the need for fiscal supervision*".

[480] See, for example, Court of Justice of the European Union, 11 August 1995, C-80/94, *Wielocks*; Court of Justice of the European Union, 21 November 2002, C-436/00, *X & Y*; Court of Justice of the European Union, 15 July 2004, C-242/03, *Weidert and Paulus*. See also Neyt, R., Peeters, S., *Balanced allocation and coherence: some thoughts in light of Argenta and K*, cited above, 67.

That being said, the concept of "the need to preserve fiscal coherence", however, often seems to overlap, in the words of the Court of Justice, with another concept put forward by the Court to justify restrictive tax measures, i.e. the need to protect a balanced allocation of taxing powers amongst Member States[481]. In fact, even though the two concept would *prima facie* seem to be different in that "fiscal coherence" deals with the symmetry of the taxes levied on a single taxpayer from an internal point of view, whereas "balanced allocation" concerns the treatment of a taxpayer at international level through forms of coordination with other jurisdictions[482], the Court has then clearly stated that "*the requirements of coherence of the tax system and the balanced allocation of powers of taxation coincide*"[483] and also, in the *N.* judgement[484], equated the fiscal principle of territoriality as mentioned in *Futura* with the preservation of the allocation of the power to tax amongst Member States. It has been convincingly argued that all of the above-mentioned concepts indicate the Court of Justice's effort to reconcile the Internal Market perspective and the almost complete lack of harmonisation in the field of direct taxes, which, in theory, would allow Member States to act to protect their tax revenuse against "territorial mismatches" of profits and corresponding losses[485].

According to some authors, the justification based on the need to ensure the balanced allocation of taxing powers Member States is the most important of all the justifications put forward by the Court and part of the legal doctrine has seen it as the reflection of the principle of fiscal territoriality[486]. In fact, in the *Marks & Spencer* judgement, for example, the Court has recognised the value of the fiscal territoriality principle, which seems to be close to the concept of the preservation of the allocation of

[481] In fact, as highlighted by Wattel, P.J., *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power: what is the difference?*, in cited above, 142, although the validity of the fiscal cohesion/coherence justification was formally reiterated, after *Bachmann*, in *Danner* (case C-136/00), the Court never accepted it again and the Author argues that it was nothing more than a "*misnomer, or a slip of a pen, or a red herring*", since "*it does not really exist as a justification, at least not separately from the analysis of the comparability of the cross-border and the internal situation*". On the same point, see also Cerioni, L., *The never-ending issue of cross-border loss compensation within the EU: reconciling balanced allocation of taxing rights and cross-border ability-to-pay*, cited above, 269; Eden, S., *The obstacles faced by the European Court of Justice in removing the obstacles faced by the taxpayer: the difficult case of double taxation*, cited above, 610.

[482] Bottazzi, C., *Tra affermazione delle libertà comunitarie e difesa della sovranità statale: la Corte di Giustizia condanna l'Italia per il previgente sistema di ritenuta sui dividendi versati a non residenti*, in Rassegna Tributaria, 2010, 2, 567; Zalasinski, A., *The limits of the EC concept of 'direct tax restriction on free movement rights', the principles of equality and ability to pay, and the interstate fiscal equity*, in Intertax, 2009, 5, 282.

[483] Court of Justice of the European Union, 29 November 2011, C-371/10, *National Grid Indus BV*. The same statement may be found, *inter alia*, also in Court of Justice of the European Union, 17 December 2015, C-388/14, *Timac Agro Deutschland GmbH*, where the Court, as we will see, also recognised that "*the objectives of safeguarding the balanced allocation of the power to impose taxes between Member States and the prevention of tax avoidance are linked*".

[484] Court of Justice of the European Union, 7 September 2006, C-470/04, *N. v. Inspecteur*.

[485] Cerioni, L., *The never-ending issue of cross-border loss compensation within the EU: reconciling balanced allocation of taxing rights and cross-border ability-to-pay*, cited above, 269.

[486] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 43; Cordewener, A., Kofler, G., Van Thiel, S., *The clash between European freedoms and national direct tax law. Public interest defences available to the Member States*, in Common Market Law Review, 2009, 1951; Lang, M., *Direct taxation: is the ECJ heading in a new direction?*, cited above, 421.

taxing powers amongst Member States, and in other occasions, such as in *Oy AA*, the Judges have referred to the same idea as the "principle of symmetry".

Notwithstanding all of the above, there is no doubt on the fact that, in this second "strain" of the Court's case law, territoriality is given a new meaning and a new relevance, as a possible justification for objectively discriminatory measures.

In *Marks & Spencer*, for instance, the Court has accepted that, by taxing resident companies on their worldwide profits and non-resident companies only on the income deriving from the activities carried out within its territory, a Member State acts in conformity with the principle of territoriality, derived from international tax law and, as seen in *Futura*, recognised by European Union law. It followed that territoriality implies that, if a Member State does not tax a foreign company on its foreign-source income because it is not established or resident in its territory, then it cannot be forced to allow said company to deduct its foreign losses against domestic profits of resident companies of the same group, since profits and losses are seen as "two sides of the same coin", which, therefore, must be treated in a symmetrical manner.

But, if we watch more closely, we cannot but notice that the *Marks & Spencer* judgement, even though, in principle, seems to "rehabilitate" the relevance of the role of the principle of territoriality in the shape of one of the possible justifications that can be put forward by Member States in case of differences in the fiscal treatment of cross-border situations and comparable merely domestic circumstances, in more practical terms, on the other hand, overrules its own reasoning in the specific case: when a territorial matching of positive and negative elements of the tax base would lead to the impossibility for a taxpayer to use the losses in any Member State, the Court's "always somewhere approach" comes to the rescue and limits the application of the principle of territoriality as not proportionate. Territoriality, therefore, cannot deprive the taxpayer of the right of deduction to which he/she/it was entitled in a merely domestic situation: that's how the "final losses" criterion was created.

In a certain sense, therefore, the *Marks & Spencer* judgement extended the application of the principle of territoriality at a truly "European level", with a perspective on cross-border loss relief that treats the Internal Market as a sole and undivided territory for that purpose: losses must always be deductible somewhere within the territory of the European Union[487].

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[487] Even though this requirement has been partially limited by the Court of Justice in its *Commission v. UK* judgement (Court of Justice of the European Union, 3 February 2015, C-172/13), where it stated that, if "*the legislation of the Member State of the subsidiary precludes all possibility of losses being carried forward*", the Member State of the parent company may refuse cross-border loss relief.

Also, it cannot go unnoticed that, always in *Marks & Spencer*, the compliance with the "fiscal principle of territoriality" is not even considered as sufficient *per se* to justify the restrictive measures enacted by the Member State concerned and needed to be paired with the analysis of two other justifications, i.e. the need to prevent tax avoidance and the need to prevent the double use of losses on the part of the taxpayer (so-called "double dip"). The same applied also in the *Oy AA* decision.

It has been argued that, with regards to cross-border loss relief, if the fiscal principle of territoriality were accepted as a justification, this would imply that Member States have a right to apply a symmetrical treatment between taxing rights and obligations to grant tax deductions. Therefore, since the Member State of the parent company does not generally tax the profits of its foreign subsidiaries, this would mean that said State would not be required to allow deduction of their losses, thereby preventing cross-border loss relief within the Internal Market and undermining the achievement of a proper integration of such Internal Market, maintaining actual differences from what can be achieved within a domestic market and a "EU cross-border market". This is probably one of the reasons that led the Court of Justice not to accept territoriality as a justification *per se* in the *Marks & Spencer* judgement.

Which brings us to the third and last step of the evolution of the Court's jurisprudence on territoriality and on the tax treatment of non-residents.

In a considerable number of its latest judgements, in fact, the Court has made it clear that the justification based on the balanced allocation of taxing powers (in other words, on territoriality) can be resorted to only in case the restrictive measure at issue is aimed at preventing taxpayer's behaviours which endanger a Member State's right to exercise its fiscal jurisdiction with regards to activities taking place in its territory (or otherwise connected to said territory). Therefore, it could be inferred that in order for the argument based on the "balanced allocation of taxing powers" to be effective and relevant the measure concerned must be aimed at countering tax evasion, tax avoidance or, more in general, abuse of law.

This, even though the Court has traditionally treated the "territorial justification" based on the balanced allocation of taxing powers and the justification based on the need to protect the financial interest of the state and to prevent tax evasion/avoidance as very different justifying grounds; even more so if we consider that the second justification has been traditionally very rarely accepted by the Court of Justice. Sometimes the two justifications were combined, as it happened, for instance, in the *Marks & Spencer* and *Oy AA* cases, but they always remained conceptually separated in the Court's analysis.

Lately, on the contrary, the Luxembourg Judges seem to have "merged" the two concepts, conditioning the possibility for a Member State to avail itself of the "balanced allocation" justification upon the presence of an actual risk of evasion or tax avoidance that needs to be prevented.

It should be incidentally noted that this approach of the Court finds its counterpart in the few positive rules posed by the European Union legislature, i.e. the Directives on (corporate) direct taxation, which enshrine specific anti-abuse clauses allowing Member States to dis-apply the benefits provided for by such Directives in case of abusive arrangements on the part of the taxpayers.

The scenario is then further complicated by the so-called "*Schumacker* doctrine", which has left a legacy which still has to be dealt with by the Court of Justice, since the Court has never actually completed the development of the doctrine, which could have led to the elaboration of a general ability-to-pay principle which, together with the non-discrimination principle, could have played a significant role in a more comprehensive theory for the allocation of taxing powers amongst Member States in the European Union, with a re-thinking of the traditional concept of "limited liability to tax"[488].

The Court of Justice has thus built an EU law principle of ability-to-pay to be applied at least to all cross-border situations involving individual taxpayers. When the principle of ability-to-pay is invoked, the Court of Justice can, therefore, request Member States to extend to an EU-wide scale their national rules shaped on such principle[489]. As far as individuals are concerned, therefore, ability to pay allows derogations to the allocation of taxing powers as traced by the Member States, with a substantial equivalence of residents and non-residents for tax purposes.

The approach held by the Court in *Schumacker*, and in subsequent judgements, even though not always coherent and consistent, has led the Court to implicitly trace a distinction between individuals and corporations as far as the allocation of taxing powers and the corresponding granting of tax allowances and other advantages amongst Member States are concerned. The principle of ability to pay seems, therefore, to constitute yet another derogation to what the Court defines as the "general principle of territoriality" recognised by Luxembourg Judges, to the aim of granting equal treatment of non-residents exercising their Treaty freedoms.

[488] Greggi, M., *Revisiting Schumacker: the role of limited tax liability in EU law*, cited above, 61. For an analysis of the implications of the "*Schumacker* doctrine" for Member States in terms of their sovereign powers to allocate tax incentives, see Traversa, E., Vintras, B., *The territoriality of tax incentives within the Single Market*, in Richelle, I., Schön, W., Traversa, E. (eds.), *Allocating taxing powers within the European Union*, Brussels, 2013, 171.

[489] Cerioni, L., *The never-ending issue of cross-border loss compensation within the EU: reconciling balanced allocation of taxing rights and cross-border ability-to-pay*, cited above, 274.

It is, however, unclear how a Member State should apply the "*Schumacker* test", verifying whether the major part of the taxable income is derived from an activity pursued in the Member State of source. Apart from the fact that it is not clear, from the Court of Justice's case law, whether reference should be made to the net or gross income of the taxpayer, the question remains as to whether this test should be conducted on a yearly basis. It is, in fact, theoretically possible for an individual taxpayer to meet the "*Schumacker* threshold" in a particular year due to the presence of losses in his/her Member State of residence, which would probably imply that the Member State of source would be forced, under this case law, to allow deduction of these foreign losses[490]. With all the unavoidable consequences for the Member States' treasuries, especially in terms of uncertainty.

Notwithstanding these more "technical" problems, which are not, however, to be disregarded as they are potentially significant, if ability-to-pay must prevail over territoriality, at least in the context of income taxation of individuals, this means that the non-resident subject should be able to ask the Member State where his/her income is located to be allowed to a sort of "worldwide taxation" in the source country, while staying subject to worldwide taxation in his country of residence, which would either have to exempt all of his/her foreign income or to grant him/her the tax credit connected to the tax paid abroad in relation to said foreign income. However, the same taxpayer would have the right to be granted a tax credit by the Member State of source as well, since tax credits generally constitute part of the treatment linked to worldwide taxation. A significant simplification of the system would be provided by the uniform implementation of purely territorial tax systems in the European Union context.

On the other hand, as far as corporations are concerned, the validity of an allocation of taxing powers based on territoriality does not seem to be derogated by any principle concerning ability to pay, given that companies do not have family or personal circumstances that need to be taken into account. Thus, a higher degree of "fiscal symmetry" between positive and negative elements would be granted, with an exception linked to the "always somewhere approach" of the Court and, more specifically, to the "final losses doctrine". On the point, it has correctly been noted that, rather than setting allocation criteria for expenses and losses, the Court of Justice has asserted the need to take into account them for tax purposes at least once[491].

[490] Marres, O., *The principle of territoriality and cross-border loss compensation*, cited above, 123. See also Bardini, C., *The ability to pay in the European Union: an impossible Sudoku for the ECJ*, in Intertax, 2010, 1, 20.
[491] Garcia Prats, F.A., *EC law and direct taxation: towards a coherent system of taxation?*, cited above, 13.

Since the Court of Justice has accepted that tax obstacles to free movement resulting from differences or overlaps in the assertion of taxing powers by Member States are outside the scope of the Treaty freedoms (because and insofar as they do not result in any discrimination on the part of the Member States involved), European Union law essentially contains no legal basis for choosing connecting factors for the definition of fiscal jurisdiction, which means that, on the ground of European Union law, it is not possible to state which one between the Member State of source and the Member State of residence has priority in its right to tax cross-border income.

Sometimes the Court has ruled in a way that could be interpreted as meaning that preference should be given to the Member State of source over the Member State of residence. For example, on one hand, the Court has often stated that the Member State of residence of the taxpayer should extend tax credits or exemptions, i.e. a favourable tax regime provided for its residents, to non-resident subjects as well, whereas, on the other hand, the Court has not deemed that the Member State of source is obliged to grant a tax credit to non-residents as well, since that would have implied that said Member State would have had to renounce its right to tax an income generated from an activity performed in its territory[492]. This is what has happened, for instance, in the *Class ACT IV* case[493].

In other cases, however, as it has been shown, the Court has allowed worldwide taxation based on the taxpayer's residence as appropriate to ensure a balanced allocation of taxing powers, even allowing an extraterritorial extension of taxing powers to non-resident subjects, for instance, in cases concerning CFC regimes, such as *Cadbury Schweppes*.

Therefore, it does not appear possible to identify a clear preference on the part of the Luxembourg Judges on which of the two opposite tax models best fits with the European Union legal order and with the unity of the Internal Market. It follows that all common and "traditional" connecting factors that are currently used by Member States are, *per se*, compatible with European Union law[494]. For example, the Court explicitly accepted worldwide taxation by the residence Member State in its *CIBA* judgement[495], where it stated that "*the Member State in which the seat of the undertakings is located enjoys, in the absence of a double taxation convention, the right to tax that undertaking overall*".

[492] De Pietro, C., *Exit tax: territorialità e mobilità societaria*, in European Tax Studies, 2009, 1.
[493] Court of Justice of the European Union, 12 December 2006, C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*.
[494] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 454.
[495] Court of Justice of the European Union, 15 April 2010, C-96/08, *CIBA*.

The implementation of a model based on source taxation for non-residents on their domestic-source income has been accepted as well by the European Union Judges, for example in the *SGI* judgement[496], where it has been stated that "*the right of a Member State to exercise its tax jurisdiction in relation to activities carried out in its territory*". The same goes for purely territorial taxation, i.e. the application by the Member State of residence of limited taxation and the source principle to its residents as well: on the point, the *Lidl Belgium* judgement[497] should be mentioned, where the Court of Justice has found that "*the preservation of the allocation of the power to impose taxes between Member States may make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses*".

The Luxembourg Judges have even accepted as compatible with EU law a model of taxation based on nationality, irrespective of the "source" and "residence" concepts, even though in the context not of income taxation, but of inheritance taxation, in the above-mentioned *Van Hilten* judgement[498]. In that occasion, in fact, the Court concluded that "*national legislation […] which provides that the estate of a national of a Member State who dies within 10 years of ceasing to reside in that Member State is to be taxed as if that national had continued to reside in that Member State, while providing for relief in respect of the taxes levied in the State to which the deceased transferred his residence, does not constitute a restriction on the movement of capital*", thus actually accepting a discrimination between nationals and non-nationals.

The Court of Justice, therefore, accepts both of the traditional models for the assertion of fiscal jurisdiction on the part of the states, which are considered to be inherenly "neutral", *per se*, as far as European Union law is concerned and escaping the reach of the prohibitions deriving from the implementation of Treaty freedoms. According to the Luxembourg Judges, the fundamental freedoms and the principle of non-discrimination, in fact, do not necessarily entail any indication as to the priority of fiscal jurisdiction, but only provide that the exercise of the taxing jurisdiction on the part of the Member States must answer to the non-discrimination principle and must not hinder the exercise of free movement for European Union citizens[499].

It has been highlighted above that the Court has accepted that Member States are not limited by European Union law in their choice of connecting factors for the allocation

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[496] Court of Justice of the European Union, 21 January 2010, C-311/08, *Société de gestion industrielle*.
[497] Court of Justice of the European Union, 15 May 2008, C-414/06, *Lidl Belgium*.
[498] Court of Justice of the European Union, 23 February 2006, C-513/03, *Heirs of M.E.A. van Hilten - van der Heijden v. Inspecetur van de Belastingdienst te Heerlen*.
[499] Wattel, P.J., *Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity: a plea for territoriality*, in EC Tax Review, 2003, 4, 199.

and exercise of their taxing powers and that residents and non-residents are not, as a rule, comparable for tax purposes, which essentially amounts to granting Member States the possibility to apply such connecting factors in an asymmetrical manner. With the exceptions of "final losses" for corporations and of the consequences of the need to take into account the taxpayer's "ability to pay" for individuals.

It goes without saying, and it has been abundantly highlighted in the previous chapter of the present research, that the simultaneous implementation of a regime entailing source taxation for non-resident subjects and worldwide taxation for residents (which constitutes a regime frequently implemented by capital-exporting countries) leads to double taxation of the income having its source in foreign territory. However, this situation does not fit into the definition of the "disparity" concept as designed by the Court in *Damseaux* or in *Kerckhaert-Morres*, since we are now analysing the hypothesis of both Member States involved implementing not different tax regimes, but, on the contrary, identical tax regimes[500]. The problem would most certainly arise also in the (hypothetical) case both Member States' tax regime would entail worldwide taxation for both residents and non-residents, although *per se* consistent and non-discriminatory, since this situation would result in double taxation of the entire income of the taxpayer concerned.

It has been observed, however, that not even the implementation, by all Member States, of a purely territorial tax regime, by virtue of which all Member States would tax both residents and non-residents only on the income produced within their respective territories, would effectively solve the problem at issue. Source taxation by both the residence and the source Member States for both residents and non-residents would, in fact, have the consequence of possibly splitting up one single tax base over two taxing jurisdictions, which would result in disadvantages for the taxpayer if his/her/its income is positive in one Member State and entirely negative in the other Member State (i.e. if a taxpayer receives his income in a Member State and suffers losses in another Member State), because the two categories of elements would not be able to cancel each other out, ensuring compensation of losses and the compliance with principles such as progressivity and ability-to-pay. This would lead to a situation which is similar to the one analysed by the Court in *Schumacker*. Therefore, the implementation of the ability-to-pay principle, as imposed by the Court at least with regards to individual taxpayers, leads to the application of a criterion that is radically different from strict territoriality,

[500] Advocate General Geelhoed defined these situations as "quasi-restrictions" (see AG Geelhoed Opinion in Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*).

leaning towards the opposte model based on worldwide taxation.

What changes is the perspective from which the Court looks at the Internal Market: either as one entity where the territorial dimension necessarily supersedes the borders of national countries or as a "sum of territories", where each Member States constitutes a separate component of a larger Single Market. It all ultimately comes to the binomial "per country"-"overall" approach.

It is certainly true that the Court's "per country approach", which seems to have prevailed in the Court of Justice's jurisprudence until today, is more respectful of the sovereign prerogatives of the Member States, acknowledging that each Member State may decide how to structure its own tax system and that, in doing so, does not have to depend on any other country. The adoption of such a model, however, seems to contradict the application of the Court's reasoning on "restrictions", focusing on a mere "discrimination-analysis".

From the perspective of the "overall approach", the combination of the obligations of the Member State of source and of the Member State of residence in light of the fundamental freedoms and of the principle of non-discrimination should be seen in its entirety, given that an analysis which is limited to the situation of a single taxpayer in the context of only one of the Member States involved in the cross-border transactions could provide a partial and unbalanced vision of the circumstances, not reflecting the economic reality in which said taxpayer acts. Furthermore, an "overall approach" to the topic would allow to take into account the allocation of taxing powers that the Member State involved, in the exercise of their sovereignty, have aimed at realising by way of bilateral tax treaties.

This type of "global" reasoning probably constitutes, *rebus sic stantibus*, the closest solution to the model of a true Internal Market, calling for a coherence that is simultaneously internal and external to the Member States, operating not only at the level of the single Member State (and of its domestic tax system), but on a higher level, i.e. the one characterised by the need of coordinating the different tax systems of the Member States in order to guarantee the functioning of a proper, undistorted and unadulterated Internal Market. These are the values at play: the affirmation of state sovereignty, on one hand, and, on the other hand, the need for a coordination of tax measures in the name of the Internal Market.

The question, therefore, is how to realise such a "coordination" of domestic tax systems without enacting interferences (which are not called for by the Treaty) in the Member States' sovereignty, in absence of any homogeneous, and legislatively

approved, method for the allocation of taxing powers covering the entire European Union territory. In the context of such a "normative void" on the part of the European Union legislature, the Court of Justice, even though, on one hand, it expressly recognises the freedom for all Member States to choose how to limit the scope of their tax jurisdiction, on the other hand, interferes in the sovereign fiscal decisions of the Member States, sometimes shaping the borders of the Member States' tax jurisdictions, even creating new taxing powers upon Member States which had previously decided, by virtue of their sovereign prerogative, not to exercise them.

Which brings us to the topic of double taxation.

The Court generally interprets international double taxation as the result of "the exercise in parallel by two Member States of their fiscal sovereignty" (such as worldwide taxation in the Member State of residence and taxation at source in the Member State of source), which has led the Luxembourg Judges to stating that, although double taxation constitutes a major obstacle to the exercise of Treaty freedoms, it cannot be remedied by relying on the fundamental freedoms, but either through EU-level harmonisation measures or bilateral (or multilateral) agreements between Member States.

One of the starting points of the discussion should, therefore, be the acknowledgement that maintaining, at the same time, the idea of a "common space" where human and productive factors are free to move without being hindered by national provisions, i.e. the Internal Market as envisaged in the Treaties as the ultimate purpose of the European Union, and the enduring power of each Member State to establish the extension of their taxing powers, even though not coordinating with other Member States' tax system, is not possible and that a choice must be made.

The Court's powers have now reached an impasse: the Court cannot, and should not, proceed any further in the enhancement of the process of intergration of the European Union. In order for the Internal Market to progress further, with a proper integration of a single market with a single territorial dimension, a legislative intervention is needed, as the "case study" concerning exit taxation has clearly demonstrated.

Exit taxation constitutes a problem which can be solved only by way of an intervention of the EU legislature: the Court has "stopped at the Member States' national borders", stating that the Member State of emigration has a right to tax the capital gains accrued at the time of exit, but has not gone as far as to stating that the Member State of destination cannot tax those items of income. This is a case in which the "balanced allocation of taxing powers" has actually failed to attain its purpose: for the Court to

state that the Member State of departure cannot tax the income accrued on its territory would have amounted to denying the Member States' freedom with concern to their direct taxes and, ultimately, their territorial sovereignty. Which led the Court to allow restrictions based on the need to protect the Member State's right to tax income produced within its territory, both from an anti-avoidance perspectice and from a more systematic and general point of view[501]. However, the Court has not even specified that the Member State of destination cannot tax the same item of income, which unavoidably leads to double taxation.

The optimal solution would probably be the establishment of a regime by virtue of which the Member State of origin might levy tax on the income accrued up until the day of departure and the Member State of destination might only tax the part of the income accrued after the emigration. This, of course, is something that the Court cannot, and should not, do. Which demonstrates the need for an intervention of the EU legislature. Starting from this assumption, the next chapter of the research will, therefore, explore what the European Union legislature has achieved, as of today, in terms of positive integration of the Internal Market with specific concern to the allocation of taxing powers amongst Member States, and what should still be done to that purpose.

Notwithstanding the conclusions that will be drawn from the analysis that is going to be conducted in the following chapter, one of the results that can be deducted from the overall examination of the Court's approach to the topic is that, in the Court's words and theories, fiscal territoriality does not appear to be a "principle" any more than under international (tax) law. The Court ultimately refers to territoriality simply by making reference to the evaluation of the criteria for the allocation of taxing powers across the Internal Market or, in any case, between two Member States in terms of their compatibility with the fundamental freedoms. That is because, as highlighted from the outset, The Court ultimately operates in a scenario that is characterised by a substantially "full" sovereignty on the part of the Member States, with no space being left to the affirmation of possible general "principles" other than those that can be directly inferred from the fundamental Treaty freedoms and the consequent need to verify the compatibility of national measures - and criteria - with the implementation of European Union law.

[501] De Pietro, C., *Exit tax: territorialità e mobilità societaria*, cited above.

CHAPTER III

THE TAX TREATMENT OF FOREIGN (CORPORATE) INCOME IN POSITIVE EUROPEAN UNION LAW: THE ROAD SO FAR AND PERSPECTIVES FOR AN IMPROVEMENT OF THE INTEGRATION OF THE INTERNAL MARKET

1. The (limited) role played by the European Union legislature in the "fiscal integration" of the Internal Market.

In the previous chapter we have tried to understand the role of territoriality in the "design" of a balanced allocation of taxing powers amongst Member States as developed by the Court of Justice's case law, from the specific perspectives of the dialectical relationship between "source countries" and "residence countries" and of the fiscal treatment of foreign income, and whether (and how) this hypothetical "design" could actually be suitable for the attainment of the ultimate purpose of the Treaties, i.e. the creation of a truly integrated Internal Market.

Such analysis has found there to be several inconsistencies in the way the jurisprudence of the Court of Justice deals with the extension of the Member States' taxing powers with regards to topics such as, for instance, international (juridical) double taxation, cross-border loss relief and exit taxation.

We have also found there to be no clear indications coming from the Court's decisions on how far Member States' sovereign powers may actually go in determining the scope of their tax jurisdictions, especially in light of the recent tendencies on the substantial "primacy" of the need to prevent tax avoidance as a paramount goal, which seems to contradict, to a certain extent, the previous case law of the Court on the point of what is considered a balanced allocation of taxing powers. This absence of clear indications in the Court's jurisprudence applies also to the question of which of the two

traditional "models" according to which countries generally shape the extension of their tax jurisdictions (worldwide taxation and territorial taxation) should be deemed as preferable for the purposes of the Internal Market, considered, as a whole, as an integrated tax jurisdiction.

One of the conclusions was, therefore, that the Court's analysis, especially as it is (necessarily) conducted on a case-by-case basis, is inherently not sufficient for the purposes of establishing a coherent approach to what should be a fair and efficient allocation of taxing powers at EU level for the purposes of the proper functioning of the Internal Market and that, consequently, an effective solution cannot but come from the intervention of the EU legislature.

In light of the above, we should now examine the current situation of European Union secondary law on direct taxation in order to verify whether or not such provisions are proof of any hypothetical "preference" for one of the two above-mentioned tax models and whether or not this hypothetical preference is in line with the principles enucleated by the Court's jurisprudence.

It should be recalled, at the outset, as mentioned in the previous chapter of the research, that the field of direct taxation has been the object of limited legislative intervention on the part of the European Union bodies, which has been, so far, confined only to a certain number of specific matters mostly concerning corporate taxation and some of its effects on cross-border business activities. This characteristic should be duly taken into account when approaching the subject of the contents of secondary EU law on the point of direct taxation, especially in the attempt to draw any general principle from such provisions.

In other words, one should always keep in mind that all positive interventions of the EU legislature in the field of direct taxation have not so far been "systematic" in any way, as they have been essentially limited to the attempt of finding solutions to very specific problems. These solutions, therefore, might not be necessarily inspired by an "overall" vision and/or interpretation of the Internal Market and of its functioning, even though it could be argued that a certain level of consistency should be sought and maintained between the general principles of the European Union legal order as described by the Treaties and by the judgements of Court of Justice, on one hand, and the normative activities of the EU legislative bodies, on the other hand.

This is essentially due, as already highlighted in the previous chapter, to the lack of an exclusive competence of the European Union in the field of direct taxation, which adds to the complications inevitably connected to the need for unanimous approval of

any measure concerning direct tax. All of these factors have significantly influenced the evolution of the European Union legislative bodies to the issues related to the effects of direct taxation in the process of integration of the Internal Market[502].

Briefly said, the first significant efforts of the EU legislature in the field of direct taxation date back to 1990, with two directives dedicated respectively to cross-border mergers and other cross-border corporate reorganisations and to a common regime of taxation in the relationships between parent companies and subsidiaries. The subsequent developments in the field came thirteen years later with a new series of provisions concerning cross-border interest and royalty payments between related (corporate) parties and taxation of interest paid to non-resident individuals[503].

Other proposals were, nonetheless, put forward by the Commission but have found no definitive legislative approval by the competent EU bodies. This is the case, for instance, of the 1975 proposal concerning harmonisation of corporate income tax systems, of withholding taxes on dividends and of the systems of "integration" of corporate-level taxation and shareholder-level taxation, or the proposal concerning the harmonisation of the rules of the determination of corporate income, or the proposal concerning harmonisation of cross-border relief or the one related to the taxation of workers moving across the European Union[504].

In light of all of the above, it can hardly be doubted that the extent of harmonisation in the field of direct taxation has, so far, been considerably limited, especially as a consequence of the fact that each decision in said field needs, as of today, to be adopted through a unanimous vote. This circumstance has led the European Union institutions to considering the option of resorting to a different type of approach, based on coordinating, rather than harmonising, domestic tax regimes. Briefly said, if

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[502] An overall analysis of the juridical, political, social and economic reasons for the substantial lack of any effective and all-encompassing approach to the topic of direct taxation in the EU, on the part both of the European Union and of its Member States, goes beyond the scope of the present research, which aims at analysing the current situation and the legal reasoning underlying the Court's jurisprudence and the EU legislative approach to the subject of the allocation of taxing powers amongst Member States and of the fiscal treatment of non-residents. For a more detailed and reasoned analysis of such problems, see, amongst others, Di Pietro, A. (ed.), *Per una costituzione fiscale europea*, Padua, 2008, *passim*; Di Pietro, A., Tassani, T. (eds.), *I principi europei del diritto tributario*, Padua, 2013, *passim*; Boria, P., *L'anti-sovrano*, cited above, *passim*; Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, *passim*.

[503] Reference is made to the so-called "Savings Directive", i.e. Directive 2003/48/EC of 3 June 2003 "*on taxation of savings income in the form of interest payments*", now repealed. The Savings Directive required automatic exchange of information amongst Member States on private savings income, enabling interest payments made in a Member State to subjects residing in other Member States to be taxed in accordance with the tax laws of the Member State of residence. The repeal was a consequence of the adoption, in December 2014, of Council Directive 2014/107/EU, amending provision on the mandatory automatic exchange of information between tax administrations. Said Directive, in fact, which entered into force on 1 January 2016, aims at implementing the OECD Global Standard on automatic exchange of financial account information within the European Union, covering not only interest income, but dividends and other types of capital income as well, having, therefore, a broader scope than Directive 2003/48/EC.

[504] Melis, G., Tiscini, R., *La tassazione del reddito di impresa: problemi attuali e prospettive di riforma in chiave comparatistica*, in Rassegna Tributaria, 2014, 1, 97.

harmonisation consists in the introduction of a common normative body within national laws, coordination, on the other hand, does not affect domestic legislation, but aims, through recommendations and directives, at making them compatible not only with the Treaties, but also amongst themselves[505].

Also as a consequence of these "failures" to reach a unanimous consensus on many of the most crucial issues for the interaction between direct taxation and the integration of the Internal Market, the policy of the Commission and of the EU legislative bodies has, so far, been aimed essentially at solving specific and "sectorial" issues concerning the effect of taxation on transnational business activities. The EU legislature, therefore, has essentially acted in order to mitigate possible market distortions arising from fiscal factors in the field of direct taxation, in order to facilitate the exercise of cross-border business activities and has, therefore, been focused almost exclusively on corporate taxation[506]. Thus, the Council enacted targeted measures aimed at removing specific obstacles to transnational economic activities, such as withholding taxes on cross-border income flows, taxation of cross-border mergers and other corporate reorganisations and burdens related to transfer pricing[507], together with measures aimed at ensuring transparency, exchange of information and, ultimately, fair tax competition amongst Member States[508]. The same approach has, more recently, been adopted with regards to the topic of prevention of tax avoidance.

In the following pages, therefore, we will analyse the most relevant provisions of the Directives on corporate taxation - and, particularly, the "Parent-Subsidiary" Directive, the "Interest and Royalty Directive" and the "Merger Directive" - in order to examine how, with regard to specific items of cross-border income, EU secondary law tries to strike a balance between the Member State's (sovereign) fiscal jurisdiction and the integration of the Internal Market. The attention will, then, be moved to the most

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[505] Aujean, M., *Le fonti europee e la loro efficacia in materia tributaria, tra armonizzazione, coordinamento e concorrenza fiscale leale*, cited above, 24.

[506] Little attention has been paid, on the other hand, to individual taxation, exception made for the - now repealed - "Savings Directive" mentioned above. The Commission had formulated some general indications on the point in its 1993 Recommendation "*on the taxation of certain items of income received by non-residents in a Member State other than that in which they are resident*" (Commission Recommendation 94/79/EC of 21 December 1993), concerning income from dependent personal services, pensions, income from professional occupations or other self-employed activities, income from agricultural and forestry activities and income from industrial and commercial activities. The 1993 Recommendation called upon Member States not to subject such items of income, "*in the Member State of taxation, to any heavier than if the taxpayer, his spouse and his children were resident in that Member State*", subject "*to the condition that the items of income […] which are taxable in the Member State in which the natural person is not resident constitute at least 75% of that person's total taxable income during the tax year*". Furthermore, the Recommendation specified that "*the Member State in which a natural person is resident may decide not to grant deductions or other tax reliefs which it normally grants to residents if that person benefits from identical or similar deductions or other reliefs in the Member State which taxes the items of his income […]*".

[507] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 125.

[508] Reference is made to Council Directive 2011/16/EU on "*administrative cooperation in the field of taxation*" and to Council Directive 2010/24/EU concerning "*mutual assistance for the recovery of claims related to taxes, duties and other measures*", which both escape the scope of the present research.

recent initiatives in the field of direct taxation, namely the so-called "Anti-Tax Avoidance" Directive and the Common Consolidated Corporate Tax Base initiatives, so as to verify whether there has been any change, in more recent times, in the approach of the EU legislature to the topic of the allocation of fiscal jurisdiction and of the extension of Member States' taxing powers.

Notwithstanding what has been clarified above with concern to the limited scope of application of such provisions and to their specific purpose, and irrespective of the actual political will to seek such a result, it cannot be disputed that the mentioned Directives have the effect to constitute a first attempt of an EU-level allocation of taxing powers amongst Member States. At least with concern to the specific fields considered by the Directives, in fact, it is undeniable that the EU legislature has made specific choices as to which role should the Member State of source and the Member State of residence play with regard to certain cross-border items of income, in terms of which of the two States should have priority to levy tax on such income and to what extent, and of which of the two States should have the obligation to remove the prejudicial effects of any double taxation arising from the interplay of the taxing powers of the countries involved.

In doing so, even though the original intention was certainly less ambitious, the European Union legislature has *de facto* taken its first (slow) steps towards the design of a "prototype" for a hypothetical future uniform allocation of taxing powers amongst Member States in the field of (corporate) income taxation, with (political) choices giving preference to one or the other Member State involved as far as taxation rights are concerned, thus implicitly recognising that the chosen model is functional and suitable for the purposes of the integration of the Internal Market, at least from the perspective of cross-border business activities and with regards to the specific items of income concerned.

2. The Parent-Subsidiary Directive.

Two different problems may arise, in the context of a group of companies, when a subsidiary located in a Member State distributes dividends to its parent company established in a different Member State: on one hand, the Member State of establishment of the subsidiary company might impose withholding taxes on such outbound dividends; on the other hand, the Member State where the parent company has its seat might include the inbound dividends within the parent company's taxable base, which

would lead to the economic double taxation of the underlying profits from which the distributed dividends derive, which would be taxed upon the subsidiary as part of its corporate income and also, indirectly, upon the parent company in the form of the dividends that the parent company receives and which form part of its taxable base for the purposes of corporation tax.

Acknowledging these problems and the risks they pose for the functioning of the Internal Market and for cross-border business activities, Council Directive 2011/96/EU (so-called "Parent-Subsidiary Directive") on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States[509] seeks to abolish tax impediments to cross-border payment of dividends within groups of companies, thus aiming at improving the functioning of the Internal Market and the implementation of the free movement of capital and of the freedom of establishment[510]. The Directive essentially aims at eliminating differences between dividend distribution in purely domestic situations and dividend distribution in cross-border scenarios.

However, as it will be shown, the Parent-Subsidiary Directive does not simply eliminate or alleviate double taxation on cross-border dividends, but reaches a sort of coordination of the taxing powers of the Member State of source of the dividends (i.e. the Member State where the subsidiary is located) and of the Member State of residence of the parent company, pursuing the objective of the highest possible level of fiscal neutrality of cross-border transfer of profits in the form of dividends.

It goes without saying that the Directive applies exclusively to cross-border situations, with parent-subsidiary relations within the same Member State or third-states scenarios not being addressed. In fact, one of the conditions established in order for the provisions at issue to apply, is that the company must be resident for tax purposes in a Member State on the basis of the national tax law of that State and it may not be resident for tax purposes outside the European Union according to a tax treaty with a non-Member State[511]. In other words, this provision disqualifies dual resident companies incorporated under the law of a Member State applying an incorporation or statutory

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[509] Directive 2011/96/EU of 30 November 2011 replaced 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, which, as the Preamble of the new Directive states, had been substantially amended several times and, therefore, a new Directive had to be recast "*in the interest of clarity*". The Parent-Subsidiary Directive has been modified in recent times by Directive 2015/121/EU, which introduced a specific anti-abuse clause.

[510] The preamble to the Directive states that the measure is aimed at eliminating the disadvantages of cooperation between companies of different Member States in comparison to cooperation between companies within one Member State and at facilitating the cross-border grouping together of companies within the European Union.

[511] Pursuant to Article 2 of the Directive, the term "company of a Member State" "*means any company which: […] (ii) according to the tax laws of a Member State is considered to be resident in that Member State for tax purposes and, under the terms of a double taxation agreement concluded with a third State, is not considered to be resident for tax purposes outside the Union*".

seat criterion for tax subjection, and which are consequently resident for tax purposes in that Member State, but which are also resident in a non-Member State according to that State's tax law on the basis of the place of effective management. Such third-State dual resident companies were probably excluded because they may be used in tax planning and avoidance schemes, as they may enjoy tax benefits (e.g. access to tax treaties) in both states where they resident for tax purposes[512-513].

The essence of the provisions of the Directive is that cross-border profit distributions paid out of after-tax profits by an EU subsidiary to its EU parent-company located in a different Member State must be exempt from dividend withholding tax in the Member State of source (provided that certain conditions are met as far as the parent company's share of the subsidiary is concerned[514]) and free of double corporate income taxation in the Member State where the parent company is established.

The Directive stipulates, therefore, that, on one hand, intragroup cross-border payments of dividends must be exempted from withholding tax by the Member State of the subsidiary and that, on the other hand, the Member State of the recipient parent company shall either abstain from levying taxes on the incoming dividend altogether or tax it and then grant a credit for the corporation tax already paid by the subsidiary in its Member State of establishment[515]. Furthermore, not a full credit, but only an "ordinary

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[512] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 307; Tenore, M., *Taxation of dividends: a comparison of selected issues under Article 10 OECD MC and the Parent-Subsidiary Directive*, in Intertax, 2009, 222; Tenore, M., *Taxation of cross-border dividends in the European Union from past to future*, in EC Tax Review, 2010, 2, 74

[513] The Directive, however, does not provide an autonomous definition of what should constitute the elements depending on which a company should be considered as a "resident" of a Member State, simply referring to the criteria employed by the Member State concerned, as was highlighted above. It is commonly observed, in fact, that European Union positive law does not entail any specific definition of "residence", not even in the context of corporate taxation or corporate law in general, and, therefore, does not establish which should be the linking criteria which should be accepted by the EU legislature for the identification of residence. See, on the point, Marino, G., *Residenza - Diritto tributario*, in *Enciclopedia Giuridica Treccani*, vol. XVII, Rome, 2008, 1, where the Author state that EU law does not entail any autonomous definition of "residence" for the purposes of preventing double taxation because this aim should be pursued by Member States through bilateral tax treaties. Another Author observes that the notion of residence, though not clearly and autonomously defined by EU positive law, has been traced in a more precise way by the Court of Justice's case law; see Ballancin, A., *Note in tema di esterovestizione societaria tra i criteri costitutivi della nozione di residenza fiscale e l'interposizione elusiva di persona*, in Riv. dir. trib., 2008, 1, 987. Furthermore, as observed by Dorigo, S., Mastellone, P., *L'evoluzione della nozione di residenza fiscale delle persone giuridiche nell'ambito del Progetto BEPS*, cited above, 64, an "impulse" towards a more autonomous EU definition of "residence" is contained in the 2011 Commission proposal for a Common Consolidated Corporate Tax Base, which suggested a tie-breaker rule pursuant to which a company that is resident in more than one Member State should be considered as residing in the Member State where its place of effective management is located.

[514] Pursuant to Article 3 of the Directive, "*the status of parent company shall be attributed at least to a company of a Member State which fulfils the conditions set out in Article 2 and has a minimum holding of 10% in the capital of a company of another Member State fulfilling the same conditions*", provided that Member States enjoy the option of requiring that the parent company maintain such holding for an uninterrupted period of up to two years (this option has been resorted to by a considerable number of Member States).

[515] Article 5 of the Parent-Subsidiary Directive provides that "*profits which a subsidiary distributes to its parent company shall be exempt from withholding tax*", while Article 4 of the Directive sets out that "*Where a parent company or its permanent establishment, by virtue of the association of the parent company with its subsidiary, receives distributed profits, the Member State of the parent company and the Member State of its permanent establishment shall, except when the subsidiary is liquidated, either: (a) refrain from taxing such profits; or (b) tax such profits while authorising the parent*

indirect credit" should be granted, since the credit for the underlying foreign corporation tax cannot exceed the amount of domestic corporation tax the Member State of establishment of the parent company levies on the gross amount of the dividends.

It should also be highlighted that the Parent-Subsidiary Directive allows the Member State of establishment of the parent company to deny the deduction from the taxable profit of such parent company of any charges related to the holding in the subsidiary (e.g. management charges, interest paid on the financing of the holding company, etc.). In fact, if a Member State opts for the exemption method, such charges must be attributed to the exempted income, and, therefore, they should be "exempted" as well, otherwise the Member State of the parent company would be essentially required to refund domestic taxes on taxable income from other sources. Under the indirect credit system, such charges are also attributed to the dividends for which credit is granted, thus reducing the amount of the maximum credit granted[516]. Many Member States have established a rule pursuant to which, in order to be deductible, expensed incurred shall be sufficiently connected to taxable income.

Such a rule has been the object of the Court of Justice's attention in the *Bosal Holding* case[517], which concerned a Dutch domestic provision pursuant to which expenses incurred by a parent company to finance or manage its subsidiary (either domestic or foreign) could be deducted by that parent company only if, and insofar as, they had been instrumental in earning profits subject to tax in the jurisdiction where the parent company sought to deduct those expenses. The fact pattern had as its object a Dutch parent company with foreign subsidiaries which were not subject to tax in the Netherlands: this situation led the Netherlands to deny the deduction from the Dutch tax base of the parent company of expenses incurred by that same parent company that were instrumental in earning such exempted income from subsidiaries that were not subject to tax.

Although the Parent-Subsidiary Directive left Member States with the choice to disregard such expenses and, therefore, the Dutch measure at issue was compliant with the provisions of the Directive, the Court nonetheless found that said Directive should

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company and the permanent establishment to deduct from the amount of tax due that fraction of the corporation tax related to those profits and paid by the subsidiary and any lower-tier subsidiary, subject to the condition that at each tier a company and its lower-tier subsidiary fall within the definitions laid down in Article 2 and meet the requirements provided for in Article 3, up to the limit of the corresponding tax due". The Court has found that Article 5 of the Directive has direct effect and can therefore be relief upon by individual taxpayers before national tax courts with priority over derogating national tax provisions: on the point, see Court of Justice of the European Union, joined cases of 17 October 1996, C-283/94, C-291/94 and C-292/94, *Denkavit Internationaal BV, VITIC Amsterdam BV and Voormeer BV vs. Bundesamt für Finanzen*.

[516] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 316.

[517] Court of Justice of the European Union, 18 September 2003, C-168/01, *Bosal Holding BV v. Staatssecretaris von Financiën*.

not be interpreted as "isolated", being it necessary to consider whether or not the measure at hand was contrary to the Treaty as well, thus interpreting the Directive in light of the conclusions reached in this respect[518].

It should be noted that the Court of Justice has subsequently upheld this reasoning, for example, in its *Groupe Steria* judgement[519], where it stated that "*it is evident from settled case law that the decision which Article 4(2) of Directive 90/435 leaves in the hands of the Member States may be exercised only in compliance with the fundamental provisions of the Treaty, in this instance Article 49 TFEU*".

Going back to *Bosal Holding*, this reasoning led the Court to consider the Dutch measure at issue to be contrary to the freedom of establishment and required the Member States to make the same choice irrespective of whether or not the subsidiary company was subject to tax in the State of establishment of the parent company and irrespective of whether or not the parent company was taxed on the capital gains of its subsidiaries. In other words, the Court did not accept that the discretion granted by the Parent-Subsidiary Directive be exercised in a different way depending on whether or not a domestic parent company holds subsidiaries subject to the taxing powers of the Member State of residence of said parent company.

The decision was met with a considerable level of surprise and criticism by legal scholarship, since, as it was shown in the previous chapter of the research, the Luxembourg Judges had previously recognised - e.g. in cases such as *Futura* and *N. v. Inspecteur* - the relevance of the "fiscal principle of territoriality", intended as the principle according to which Member States are allowed, *inter alia*, not to grant deductions for expenses and other negative elements connected to items of income on which they choose not to levy tax. Pursuant to this more "traditional" line of thinking, it would have been expected that the Court, in the *Bosal Holding*, case would allow the Netherlands to ensure that only charges attributable to the Dutch taxable profit could be deductible from Dutch tax base.

In *Bosal Holding*, however, the Court seems to recognise its previous acceptance of territoriality as a reason to exclude the discriminatory nature of a tax provision, nonetheless explicitly specifying that the "*Futura* doctrine" concerned the taxation of a single company carrying on business in two Member States through a permanent establishment (branch), thus tracing a difference between that circumstance and the situation of a parent company in relation to the profits of its subsidiaries, since parent

[518] Weber, D., *The Bosal Holding case: analysis and critique*, in EC Tax Review, 2003, 4, 222; Lyons, T., *Tax in a Single Market: Bosal and Marks and Spencer PLC*, in British Tax Review, 2003, 6, 444.
[519] Court of Justice of the European Union, 2 September 2015, C-386/14, *Groupe Steria SCA*.

companies and their subsidiaries constitute separate legal entities: the profits of the subsidiaries are not, in fact, generally taxed in the hands of the parent company[520].

The Court essentially argued that the principle of territoriality, as recognised and described in *Futura*, concerned only the situation of one taxpayer. The Judges, therefore, seem to have somehow disregarded the relevance of territoriality as postulated in the *Futura* judgement[521]: it has been argued, in fact, that, in terms of discrimination, the situations of two different taxpayers are only comparable to the extent that the Member State exercise the same tax jurisdiction over both of them, which could be consistent with the general principle according to which it is for the Member States to decide what falls within their respective fiscal jurisdictions[522].

The Court's ruling in *Bosal Holding*, therefore, has shed a different light on the Court's interpretation of the concept (or principle) of "territoriality", which might seem to be, in *Bosal Holding*, partially different than the one on which the *Futura* judgement was based. As highlighted above, in *Futura* the Court, resorting to a notion of "territoriality as a principle", as opposed to the concept of "territoriality as a criterion" (as a synonym of "limited taxation" or "taxation at source"), assumed the principle of territoriality to be applied to residents when they are taxed on their worldwide income and to non-residents subject to limited liability. It did not consider the admissibility, under European Union law, of a measure by way of which tax is levied on residents not on their worldwide income, but rather only on domestic income, thus applying what has been defined as "territoriality as a criterion". The reasoning seems quite similar to the "always somewhere approach" which the Court applied, for example, in the *Marks & Spencer* case[523].

In *Bosal Holding*, the Court did not reject the application of "territoriality as a criterion" to residents as such, but limited it to the taxation of one single taxpayer,

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[520] Weber, D., *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, cited above, 595; Kingston, S., *The boundaries of sovereignty: the ECJ's controversial role applying Internal Market law to direct tax measures*, cited above, 301.

[521] Wattel, P.J., *Red herrings in direct tax cases before the ECJ*, cited above, 89.

[522] For example, AG Geelhoed has stated, in its Opinion on the *Test Claimants in Class IV of the ACT Group Litigation* case (C-374/04), that in *Bosal Holding* the Court of Justice showed insufficient respect for the allocation of taxing rights amongst Member States, pointing out as follows: "*The division of tax jurisdiction between the Netherlands and the Member States of residence of the subsidiaries was such that jurisdiction to tax the foreign subsidiaries' profit fell solely to the latter, i.e. the source State. As a result it would seem to be wholly consistent with this division of jurisdiction for the Netherlands to allocate those charges paid by the Dutch parent, which were attributable to the exempted profits of the foreign subsidiaries, to the Member States of the subsidiaries. In other terms, it would seem clear that the position of a domestic parent company with a subsidiary whose profits are taxable in the Member State, on the one hand, and such a parent company with a subsidiary whose profits are not taxable (exempt) in that Member State, on the other hand, are not comparable. In sum, this would appear to be a classic example of a difference in treatment resulting directly from dislocation of tax base. It seems to me that the result of the ECJ's judgement was to override the Member States' choice of division of tax jurisdiction and priority of taxation, which choice lies solely within Member States' competence*" (point 63). On the point, from a critical perspective, see also Wattel, P.J., *Red herrings in direct tax cases before the ECJ*, cited above, 89.

[523] On the point, see the previous chapter, paragraph 6.

disallowing the allocation of the parent company's costs and losses to the activities of a different taxpayer, i.e. a subsidiary established abroad[524]. Therefore, the Court of Justice has not, so far, ever denied the possibility for a Member State to apply a strictly territorial tax system with respect to residents as well.

Going back to the provision of the Directive, it has been highlighted above that the Member States of establishment of the parent companies are left with a choice between exempting the incoming dividend from tax and granting a credit for the corporation tax already paid by the subsidiary in its Member State of establishment. Both methods were and still are used by Member States in their domestic laws[525].

The wording of the Directive does not prevent Member States from applying both methods in the implementation of the Directive itself, depending on the circumstances (e.g., on whether a tax treaty is in force with the Member State of the subsidiary, on whether the level of effective taxation in the Member State of the subsidiary is comparable with the level of effective taxation in the Member State of the parent company).

The Court of Justice of the European Union accepted, for example, in the *Test Claimants FII GLO*[526] case and in the joined cases *Haribo* and *Salinen*[527], an asymmetrical choice by the Member State of the parent company, exempting domestic dividends on one hand and granting a credit for cross-border dividends on the other hand, since, according to the Luxembourg Judges, neither the Parent-Subsidiary Directive nor the fundamental Treaty freedoms require the Member State of the parent company to apply the same system of prevention of economic double taxation to cross-border and domestic intercompany dividends, as exemption and credit are considered as "equivalent".

It could be argued, however, that such a statement goes in the opposite direction of what the Court of Justice had previously found in its *Bosal Holding* judgement[528], where an almost identical "asymmetrical" choice made on the basis of the same provision of the Directive was deemed incompatible with the fundamental Treaty freedoms.

Also, irrespective of what has been stated in *Bosal Holding*, it should also be noted that the exemption method and the credit method are not really "equivalent" as far as

[524] Weber, D., *Is the limitation of tax jurisdiction a restriction of the freedom of movement?*, Paper for the Annual Conference of the European Association of Tax Law Professors, cited above.
[525] It has already been noted in the first chapter of the research that, in general terms, states exempting foreign-source income adhere to a model of capital import neutrality, whereas states implementing the credit method are closer to the idea of investment neutrality in the home market, i.e. to capital export neutrality.
[526] Court of Justice of the European Union, 12 December 2006, C-446/04, *Test Claimants in the Franked Investment Income Group*.
[527] Court of Justice of the European Union, 10 February 2011, joined cases C-436/08 and C-437/08, *Haribo* and *Österreichische Salinen*.
[528] Court of Justice of the European Union, 18 September 2003, C-168/01, *Bosal Holding BV v. Staatssecretaris von Financiën*.

the position of the taxpayers is concerned, leading to possible discriminatory effects on parent companies of foreign subsidiaries. Just to mention one of the differences between the two methods, the credit method implies considerable administrative burdens (and costs), which makes said method significantly more cumbersome for the parent company, which must demonstrate the amount of the foreign corporation tax attributable to the distributed profit of the foreign subsidiary, whereas the exemption of domestic dividends fully protects a parent company of domestic subsidiaries against these procedural and administrative obstacles[529]. Yet, the Court of Justice has consistently stated that the fundamental freedoms prohibit all discrimination, including minor one and administrative ones[530].

Moreover, one should also consider that the tax at the level of the subsidiary company may be lower than at the level of the parent company, as an effect of benefits such as loss relief, foreign tax credit, tax incentives and so on. The effect of such advantages at the level of the subsidiary would not be touched by taxation in the state of establishment of the parent company under an exemption system. By contrast, similar foreign reliefs and incentives at the level of the subsidiary company could be deprived of any actual effect under an indirect credit system[531]: reducing the amount of tax paid abroad means also reducing the amount of credit granted by the state of establishment of the parent company, thus impairing the effects of the advantages granted by the source state.

That being stated, and even though the Directive leaves the Member State a choice between exemption and credit, some authors have argued that there would be signs that exemption might become the only single method applied at the European Union level for the prevention of double taxation of intra-group profit distributions. This opinion is based on the fact that, as it has been observed, that many Member States that, in their domestic tax laws, generally resort to the credit method prefer the exemption method when implementing the Parent-Subsidiary Directive[532]. Also, the CCCTB proposal only provides for exemption of third-state subsidiary dividends as well.

All of the above demonstrates that the "Parent-Subsidiary" Directive is not merely aimed at the elimination or alleviation of (both juridical and economic) double taxation on cross-border intra-EU dividends, but also constitutes a first attempt of coordinating the exercise of taxing powers of the Member State of source, on whom is

[529] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 312.
[530] On the point, see, for example, Court of Justice of the European Union, 28 April 1998, C-118/96, *Jessica Safir*.
[531] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 313.
[532] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 314.

imposed a duty to refrain from levying withholding taxes on outbound dividends, and of the Member State of residence, which is called to remedy the problems related to economic double taxation of the underlying profit either by way of the exemption method or by way of the credit method.

That being said, in light of all of the above, it can be stated that the analysis of the Parent-Subsidiary Directive does not show any definite preference, on the part of the European Union legislature, for one of the two traditional tax models, the provisions of said Directive being substantially "neutral" on the point. The choice concerning which of the two models to implement is, in fact, essentially left to the Member States. This characteristic can also be seen as the consequence of the fact that the Directive aims at preventing both juridical double taxation of cross-border dividends and economic double taxation of the underlying profits, with two perspectives necessarily intertwining: the perspective of the Member State of establishment of the subsidiary - which is treated both as the "Member State of residence" with regard to the subsidiary and the "Member State of source" with concern to the dividends - and the perspective of the Member State of establishment of the parent company, which, from the point of view of the Directive, assumes only the role of "Member State of residence".

On one hand, therefore, if we analyse the Directive from the subsidiary's point of view, its provisions show a substantial tendency towards the guarantee of effective tax territoriality: the subsidiary's income is taxed by the country where the subsidiary resides, but that country's taxing powers do not extend to the outbound dividends, which become part of the income attributed to a different subject, i.e. the parent company, with the "source Member State" having to refrain from imposing any sort of withholding tax on such items of income.

On the other hand, if we analyse the Directive from the point of view of the parent company, the choice between the implementation of a "worldwide tax model" and the implementation of a "territorial tax model" is left to the Member State where the such parent company resides. In fact, inbound dividends might theoretically be taxed in the Member State of residence of the parent company, which, however, must grant a credit for the foreign tax paid abroad on the subsidiary's underlying profits: in this case, the Member State concerned would substantially opt for the implementation of a "worldwide tax model", adhering to a perspective of capital export neutrality. As an alternative, the Member State might exempt inbound dividends and, in doing so, would essentially enact a more strictly territorial tax model. Such freedom of choice has been generally confirmed also by the Court of Justice's jurisprudence, as shown above.

This apparent "interchangeability" of tax models and the freedom of choice of the Member States concerned on the point is confirmed by the fact that the Directive leaves to the Member State of residence of the parent company the choice on whether or not to grant a deduction from the parent company's corporate income of expenses connected to the foreign subsidiary: this choice would prove a tendency, on the part of the Member State concerned, either towards territorial (source) taxation or worldwide taxation. The choice, however, seems to have been somehow limited and, to a certain extent, "steered" by the Court of Justice, as the analysis of the *Bosal Holding* judgement has demonstrated, looking at the Internal Market and at the European Union territory as a whole, from an "overall" perspective, and applying the "always somewhere" approach, with a consequent derogation to tax territoriality.

That being established, it is also interesting to note that the Court of Justice, in application of its "restriction analysis" as described in the previous chapter of the present research, has progressively widened the scope of application of the Parent-Directive Directive both in the Member State of residence and in the Member State of source of the income[533].

For example, in its judgement on the *Test Claimants in Class IV of the ACT Group Litigation* case, the Court stated that "*the mere fact that, for holdings to which Directive 90/435* [i.e. current Directive 2011/96/EU] *does not apply, it is for the Member States to determine whether, and to what extent a series of charges to tax and economic double taxation are to be avoided and, for that purpose, to establish, either unilaterally or through DTCs concluded with other Member States, procedures intended to prevent or mitigate such a series of charges to tax and that economic double taxation, does not of itself mean that the Member States are entitled to impose measures that contravene the freedoms of movement guaranteed by the Treaty. Thus, where a Member States has a system for preventing or mitigating a series of charges to tax or economic double taxation for dividends paid to residents by resident companies, it must treat dividends paid to residents by non-resident companies in the same way*"[534].

Notwithstanding this statement, the Court, however, has never, until today, interpreted the obligation imposed on Member States to equally prevent double taxation for foreign-source dividends and for domestic-source dividends as entailing a prohibition for Member States to resort to different methods for doing so (e.g., a tax credit for foreign-source dividends and exemption for domestic-source dividends). It has

[533] Traversa, E., *Il divieto di doppia imposizione*, cited above, 343; Rainegard de la Bléthiere, E., *EU Report*, in *Key practical issues for the elimination of double taxation*, IFA Cahiers, vol. 96b, 2011, 64.

[534] Court of Justice of the European Union, 12 December 2006, C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*. A similar statement may be found in Court of Justice of the European Union, 8 November 2007, C-379/05, *Amurta*.

been argued that this approach is the result of a wider implementation, on the part of the Court, of the same mechanisms enshrined in the Parent-Subsidiary Directive, which, as seen above, leaves Member States with the possibility to freely choose which of the two methods to implement[535].

Finally, it should be recalled that all of the above is made conditional upon the "anti-abuse clause" which has been recently added to the Parent-Subsidiary Directive[536], by virtue of which Member States shall not grant companies the benefits provided for by the Directive "*to an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances*".

3. The Interest and Royalty Directive.

It has been argued that, in the context of the European Union Internal Market, withholding taxes on cross-border interest and royalty payments between EU companies pose less of a problem as far as risks of double taxation are concerned than withholding taxes on dividends, since many Member States, in practice, do not levy any withholding tax on outbound interest and royalties. Furthermore, unlike dividend payments, interest and royalty payments, if we exclude the effects of thin capitalisation regimes and similar limitation on interest deduction posed by domestic laws, are generally deductible from the taxable profit of the company making the payments, which considerably prevents the effects of double taxation amongst European Union Member States[537].

Notwithstanding all of the above, Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (the "Interest and Royalty Directive") was put in place in order to eliminate juridical double taxation and administrative and cash-flow disadvantages of cross-border intra-group interest and royalty payments as compared to similar purely domestic payments. According to the Preamble of the Directive, one of its collateral aims is to ensure that interest and royalty payments are taxed at least one in a Member State.

[535] Traversa, E., *Il divieto di doppia imposizione*, cited above, 344; Rainegard de la Bléthiere, E., *EU Report*, cited above, 64.
[536] Article 1(2) of the Parent-Subsidiary Directive. The provision has been added by Council Directive 2015/121/EU of 27 January 2015 "*amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States*".
[537] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 387.

The subjective requirements for the possible application of the Interest and Royalty Directive are the same as for the Parent-Subsidiary Directive and the Merger Directive: the benefits must be granted exclusively to companies which are resident, for fiscal purposes, in one of the Member States without at the same time being considered as residents of a third country under a tax treaty. With one more specification which further restricts the scope of application of the measure: in order to qualify for the benefits granted by the Directive, a company of a Member State must also be associated with the company of another Member State in favour of which the payment of interest or royalties is made[538].

The core of the Interest and Royalty Directive is that taxation of interest and royalty payments in their Member State of source is prohibited, while taxation in the Member State of the beneficial owner of such payments is imposed. The Member State of the paying company, therefore, must exempt from tax, whether levied by withholding tax at source or by assessment, any royalty or interest payment made to a beneficial owner which is an associated qualifying company located in another Member State[539].

The idea behind this choice is that interest and royalty income within groups of companies should be taxed in the jurisdiction where the related expenditure (e.g. the cost of raising capital, the cost of research and development activities, etc.) is deducted, thus implementing a sort of alignment between positive elements and negative elements, in light of a mechanism similar to what constitutes "balanced allocation" according to the Court of Justice.

As opposed to what has been highlighted above concerning the Parent-Subsidiary Directive, it is somehow easy, with regard to the Interest and Royalty Directive, to identify a substantial preference for a fiscal system based on taxation in the Member State of residence. The operative part of the Directive, in fact, does not take into account the country of origin of the interest and royalty payments concerned and the Member State of source does not have any right to tax such outbound payments paid by a company residing in its territory, which form the taxable base of a foreign company (from its point of view): taxation is, therefore, left to the Member State of residence of the company receiving such payments. Obviously, in this case no problem regarding economic double taxation arises, since the items of income concerned represent a cost for

[538] For a definition of what constitutes an "association" for the purposes of the Interest and Royalty Directive, see Article 3(b) of the Directive itself.
[539] In order to qualify as "beneficial owner" of such payments, the recipient company must receive the payments for its own benefit, i.e. not as an intermediary for another (physical or legal) person. Briefly said, the provision aims at excluding conduit companies, artificially interposed by non-qualifying creditors (for example, third-state subjects) in order to become eligible for the benefits granted by the Directive.

the company paying such sums (which, depending on the national regime applicable, could also be deducted from the company's taxable income).

Some authors have criticised the allocation of tax revenue put in place by the Interest and Royalty Directive, stating, for example, that provisions such as those enshrined in the Directive would encourage fiscal competition amongst Member States and provides tax-planning opportunities. Part of the legal literature has also noted that, if, on one hand, there is a certain level of coherence in granting the Member State of residence of the creditor the right to tax the proceeds of the capital or of the piece of intellectual property at issue (since it is in that State that the expenditure for raising capital or for research and development has been suffered and can generally be deducted), on the other hand, abolition of source taxation on deductible payments would amount to an arbitrary division of tax revenue amongst Member States: the only reason underlying such mechanism would be that income from equity investment is taxed in the Member State of investment because dividends are not deductible, whereas income from loan investment is taxed in the State of residence of the investor because interest is deductible[540].

4. The Merger Directive.

Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States[541] has, amongst its main objectives, the removal and prevention of the tax issues arising from the joining together of two or more companies from different Member States and from the division of a company into separate entities from different Member States[542]. The Directive, in other words, is aimed at ensuring that Member States do not hinder the enactment of cross-border company

[540] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 400.
[541] Initial proposals for a "Merger Directive" date back to 1969. In 1990, Council Directive 90/434/EEC of 20 August 1990 was adopted, covering mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States. The text was then amended by Directive 2005/19/EC of 17 February 2005, which substantially widened the subjective and objective scope of application of the first version of the Directive, thus including the Societas Europaea (SE), the Societas Cooperativa Europaea (SCE) and several entities not covered by the former version as well as hybrid entities. With regards to the objective scope, partial divisions and the transfer of the registered office of an SE or SCE from one Member State to another were covered. Because of the several amendments, the Merger Directive was codified in 2009 to enhance clarity; however, the codification did not lead to changes of the content of the Directive.
[542] In order to be entitled to the benefits provided by the Merger Directive, the companies involved in the operations covered must qualify as a "*company from a Member State*". Article 3 of the Directive establishes the same requirements for that status as those listed in Article 2 of the Parent-Subsidiary Directive: legal form, fiscal residence in the EU (and the companies may not be resident for tax purposes outside the Union pursuant to a tax treaty concluded between a Member State and a third country) and the need for such companies to be subject to a corporation tax-

reorganisations by way of restrictions of a fiscal nature: as clarified in its Preamble, the ultimate objective of the Merger Directive is to ensure that cross-border company reorganisations are "fiscally neutral" in the same way as purely domestic reorganisations are[543].

Starting from the assumption that, in absence of any specific tax provision, company reorganisations will generally trigger immediate taxation of unrealised capital gains, the Directive basically provides for a common system of deferral of taxation of capital gains and tax-free reserves on the occasion of a cross-border merger, division, asset merger or share merger: tax liability at the time of the operation is thus deferred to the later moment of realisation by way of a carry-over of the tax value of the assets and liabilities transferred and the shares exchanged.

Therefore, Member States must refrain from taxing any capital gains arising on the occasion of a cross-border operation falling within the scope of application of the Directive[544]. The potential tax due on such reserves accrued prior to the transaction is shifted to the receiving company, which must enter the transferred assets and liabilities in its account at the same tax value as that assigned to them in the transferring company's accounts prior to the transfer. Where the receiving company disposes of the assets transferred by way of such an operation, tax will be levied on that occasion on the difference between the disposition price and the book value of the assets prior to the merger[545-546].

The Merger Directive provides for another requirement in order for the operation to enjoy the above-mentioned benefits: cross-border mergers, cross-border divisions and cross-border assets transfers shall not give rise to any taxation of capital gains only if and insofar as the assets and liabilities transferred remain effectively connected, through a

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[543] Traversa, E., *Il divieto di doppia imposizione*, cited above, 340.

[544] More specifically, in a merger, a division or an asset merger, the assets and liabilities transferred must enter the accounts of the receiving company at the same tax value assigned to them in the transferring company's accounts immediately prior to the transfer.

[545] Similarly, a person which, in the context of a merger, exchanges his/her/its shares in a company for shares in another company shall not be taxed on the consequent possible capital gain at the time of such exchange. The 2005 amendment of the Directive added a similar tax deferral rule for the case of a transfer of the registered office of a Societas Europaea (SE) or of a Societas Cooperativa Europaea (SCE) from one Member State to another and for mergers involving SEs or SCEs.

[546] Whereas, in the case of SEs or SCEs transferring their effective management abroad, no assets are transferred, not shares, but a resident taxpayer becomes a non-resident taxpayer in the Member State of departure, thus becoming subject to tax in such State only with regards to income having its source therein, and at the same time becoming resident, thus subject to unlimited tax liability, in the Member State of entry. According to the case law of the Court of Justice, also national legal forms of company may benefit from comparable deferral and carry-over rules on the basis of the freedom of establishment provided by the Treaty, as the requirement to pay tax upon the cross-border transfer of the seat of an undertaking, when no gains are realised nor any income is derived, was held to be disproportionate by the Court in the *National Grid Indus* case (C-371/10), as we will see more in detail when talking about exit taxation in the context of European Union law. It has also been observed that the tax claim on the capital gain is connected to the assets, but is then carried over to another person, i.e. the receiving company, while, in the context of a share merger, the tax claim on the capital gain remains with the same person, i.e. the shareholder, but is rolled over to other shares, i.e. the shares received in exchange

territorial nexus, to a permanent establishment in the State of their fiscal location before the operations[547]. The rationale behind this requirement is to ensure that the Member State within whose jurisdiction the unrealised gains have accrued retains fiscal jurisdiction over the assets to which such unrealised gains are attached, thus safeguarding the taxing rights and financial interest of the Member State of the transferring company, especially since, in general terms, under international tax treaty law a state may only tax profits derived by non-residents if those profits are sources within its territory[548].

Like the Parent-Subsidiary Directive and the Interest and Royalty Directive, the Merger Directive includes a general anti-abuse clause, pursuant to which a Member State may deny the Directive benefits where it appears that one of the operations at issue "*has as its principal objective or as one of its principal objectives tax evasion or tax avoidance*"[549].

In light of all of the above, with regard to the Merger Directive, the tendency of EU secondary law appears to be substantially different from the ones described above with concern to the Parent-Subsidiary Directive and the Interest and Royalty Directive. It would, in fact, appear that, in the dialectical relationship between "residence countries" and "source countries", the Merger Directive gives preference to the Member State of source, thus being in line, at least partially, with the Court of Justice's jurisprudence on exit taxation and calling for an allocation of taxing powers based on criteria of a territorial nature.

That being established, it should be noted that part of the legal scholarship has also observed that the "permanent establishment requirement" is aimed at ensuring both jurisdiction for the source Member State and prevention of double taxation in the home State, as the presence of a branch is the connecting factor for source state taxing jurisdiction and for the home state obligation to prevent double taxation under

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[547] If Article 4.1 provides that "*a merger, division or partial division shall not give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes*", Article 4.2 establishes that "*for the purpose of this Article, the following definitions shall apply: […] (b) 'transferred assets and liabilities': those assets and liabilities of the transferring company which, in consequence of the merger, division and partial division, are effectively connected with a permanent establishment of the receiving company in the Member State of the transferring company and play a part in generating the profits or losses taken into account for tax purposes*". A similar requirement is established by Article 12 of the Directive for the case of migration of a SE or SCE, which must remain effectively connected with a branch of the SE or of the SCE in the Member State of departure in order to enjoy the benefits provided for by the Directive.

[548] As clarified in the Preamble of the Directive, these provisions - starting from the assumption that "*in respect of mergers, divisions or transfers of assets, such operations result either in the transformation of the transferring company into a permanent establishment of the company receiving the assets or in the assets becoming connected with a permanent establishment of the latter company*" - create a system of "*deferral of the taxation of the capital gains relating to the assets transferred until their actual disposal which applied to such of those assets as are transferred to that permanent establishment, permits exemption from taxation of the corresponding capital gains, while at the same time ensuring their ultimate taxation by the Member State of the transferring company at the date of their disposal*".

[549] Article 15 of the Directive specifies that "*the fact that the operation is not carried out for valid commercial reasons such as the restructuring or rationalisation of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives*". For an interpretation of such a rule, see Court of Justice of the European Union, 17 July 1997, C-28/95, *Leur-Bloem v. Inspecteur*.

international tax treaty law: if the assets and liabilities transferred in a cross-border merger were not part of a branch in the Member State of the transferring company (i.e. the departure Member State), then that Member State would lose tax jurisdiction over them and would not be able to enforce its taxing rights with regards to the capital gains and tax reserves in the future. In light of these considerations, several authors have defined the provisions described above as "claim savers", ensuring that future realisation of the deferred capital gains will be part of the tax base allocated to the Member State of the transferring company[550].

However, as highlighted by part of the legal scholarship, it would appear that the Court of Justice of the European Union prohibited the imposition of such "permanent establishment requirement" as disproportionate in case of corporate migration in the context of exit taxation, as consistently stated by the Luxembourg Judges with regard to cases like *National Grid Indus*[551], *Commission v. Denmark*[552], *DMC*[553] and *Verder*[554]. If viewed from this perspective, then the fact that gains on assets that do not remain connected to a permanent establishment located in the Member State of residence of the transferring company would be subject to immediate taxation in the event of a cross-border corporate reorganisation, without any option for a deferral of such tax, could theoretically constitute a hypothetical undue restriction on freedom of establishment.

On the other hand, some authors have argued that the provision at issue would not automatically generate any restriction on Treaty freedoms, since the Merger Directive simply provides a sort of "safe harbour" for the assets that, in the context of a cross-border reorganisation, retain their territorial connection with the Member State of "emigration", or, better said, the Member State of the transferring company, guaranteeing that the gains accrued on such assets at the time of the transfer must escape immediate taxation. With regards to assets that do not remain territorially linked with the Member State of the transferring company, the Directive does not (explicitly) allow Member States to immediately levy tax on the relevant capital gains at the time of the transfer, but simply remains silent on the point, which, according to some authors, would be different than implicitly justifying immediate tax charges[555].

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[550] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 347.

[551] Court of Justice of the European Union, 29 November 2011, C-371/10, *National Grid Indus BV*.

[552] Court of Justice of the European Union, 18 July 2013, C-261/11, *Commission v. Denmark*.

[553] Court of Justice of the European Union, 23 January 2014, C-164/12, *DMC*.

[554] Court of Justice of the European Union, 21 May 2015, C-657/13, *Verder LabTec GmbH & Co. KG*.

[555] Jiménez-Valladolid de L'Hotellerie-Fallois, D.J., *The permanent establishment: still a (permanent) requirement?*, in EC Tax Review, 2014, 4, 13. For a different opinion, see, for instance, Velde, I.V., *How does the CJEU's case law on cross-border loss relief apply to cross-border mergers and divisions?*, in EC Tax Review, 2016, 3, 144: according to the Author the "recapture rule" established for by Article 10 of the Directive, according to which the Member State of the transferring company "*may reinstate*" the losses of the permanent establishment that had previously been

A similar problem has been identified by legal scholarship with regards to another aspect of the Merger Directive's provision, with specific concern to the issue of losses.

With regards to the question of relief for the unused losses possibly accrued by one of the companies involved in the cross-border reorganisation, Article 6 of the Merger Directive provides that, to the extent the Member State of the transferring company would, in a comparable purely domestic situation, allow the receiving company to take over, and use for tax purposes, the losses of the transferring company that had not yet been exhausted, such treatment must be extended to cross-border reorganisations of companies as well, allowing the receiving company's permanent establishment to take them over[556].

This provision appears to be substantially "neutral" from the point of view of the allocation of taxing powers amongst Member States, its rationale being based simply on the need to prevent discriminatory treatments for cross-border situations if compared to purely domestic ones.

It is also true, however, that, according to the "principle of territoriality" as developed by the Court of Justice, every country should levy tax on the income of a non-resident only if said income is somehow connected to its territory, which also means that, in general terms, according to this interpretation of territoriality, deductions should be granted only in relation to costs which are connected to the income-producing process having place in the relevant country. This is the consequence of the principles formulated by the Court, for instance, in its *Futura* judgement[557].

If seen from this perspective, Article 6 of the Merger Directive would seem to sacrifice the principle of territoriality as developed by the Court of Justice "at the altar" of the need to prevent possible discriminatory measures, thus implementing a logic which seems similar to the one followed by the Court, for instance, in the *Marks & Spencer* case: from this point of view, the losses suffered by the transferring company could be seen as "final losses"[558], since the transferring company would not be able to use them any longer as a result of the cross-border reorganisation it took part in.

This is even truer if we consider that the apparent "neutrality" of the Mergers

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deducted in the taxable profits would seem to suggest a confirmation that such recapture is indeed allowed by the Merger Directive.

[556] On the point, see Helminem, M., *Must the losses of a merging company be deductible in the state of residence of the receiving company in EU?*, in EC Tax Review, 2011, 4, 172. See also Larking, B., *The Merger Directive: will it work?*, in European Taxation, 1990, 366.

[557] See the previous chapter of the research, at paragraph 4.

[558] For an analysis of the Court's "*Marks & Spencer* doctrine", see the previous chapter of the research, at paragraph 6.

Directive's measures concerning losses has been somehow limited and tempered by the Court of Justice's intervention.

In fact, the Directive does not encompass any explicit provision with regards to the possibility for the losses of the merging company to be considered as tax-deductible by the receiving company in its Member State of residence. In other words, the Merger Directive does not require that the Member State of residence of the receiving company allow such company to deduct the losses of the foreign merging company, even if a permanent establishment would be left in the Member State of residence of the merging company. Therefore, the fiscal treatment of such cross-border losses depends on the domestic provisions of the Member State concerned[559].

However, the fact that the Member State of the receiving company is under no obligation, under the Merger Directive, to allow the "import" of the losses of the transferring company does not automatically exclude that such an obligation could exist not based on the Directive, but rather on primary law[560].

This was the question the Court dealt with in the *A Oy* case[561]. The Judges, after having confirmed that Article 49 TFEU applied to the case at hand and that Member States are under the obligation to respect not only the Directive, but also the freedom of establishment when cross-border mergers are concerned, acknowledged that the Directive does not concern the problem of whether the Member State of the receiving company should grant relief for the transferring company's unused losses.

More in detail, AG Kokott, in her Opinion on the case at issue, recognised that, under the Merger Directive, losses can only be used in the transferring company's Member State, but also argued that this circumstance does not rule out that the tax law of the Member State of establishment of the receiving company could be considered as being in breach of the fundamental freedom of establishment if it prevents losses from being taken into account in the latter Member State. On this point, the Advocate General also considered that the Merger Directive "*may not have done everything that is necessary to ensure the removal of tax disadvantages for cross-border mergers*", which gives the Court space to intervene to "fill in the gaps" left by the European Union legislature.

And that is precisely what the Court did. The Judges, in fact, ruled that the national measure restricting the possibility to use such losses in the Member State of the

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[559] As observed by Helminem, M., *Must the losses of a merging company be deductible in the state of residence of the receiving company in EU?*, cited above. 173, many Member States do not allow such losses to be taken into account for tax purposes, with problems of compatibility with European Union law arising with regard to those Member States applying the credit method instead of the exemption method in relation to permanent establishments.

[560] Velde, I.V., *How does the CJEU's case law on cross-border loss relief apply to cross-border mergers and divisions?*, cited above, 134.

[561] Court of Justice of the European Union, 21 February 2013, C-123/11, *A Oy*.

receiving company generated an undue restriction of freedom of establishment, since it prevented the taking into account of losses in a cross-border merger with a subsidiary located in another Member State, whereas in a purely domestic merger such takeover of losses would have been allowed. The measure was considered as being, in principle, justified by the need to safeguard the balanced allocation of taxing powers amongst Member States, combined with the need to avoid the risk of losses being used twice ("double dip"). However, the Luxembourg Judges ruled that the provision was disproportionate since those losses should have been considered as "final losses" under the meaning of the *Marks & Spencer* case law, given that all possibilities to use them in the Member State of the transferring company had been exhausted, and, therefore, their deduction should have been allowed "somewhere" in the Internal Market, i.e. in the Member State of establishment of the receiving company. In doing so, the Court explicitly clarified its position according to which the (still vague) "final losses criterion" does not apply only to group relief cases, but also to situations concerning cross-border mergers, such as that at issue in *A Oy*[562].

Embracing the reasoning of the Court of Justice as described above implies acknowledging that a national measure which is compliant with European Union secondary law is not also necessarily compatible with EU primary law and, in particular, with the Treaty freedoms or the principle of non-discrimination. Some authors have even argued that the Court's reasoning underlying the *A Oy* decision would imply that a provision of the Merger Directive can be considered as in breach of EU primary law and thus be overruled by the Treaty principles[563].

This last conclusion, however, does seem to take a step too far and does not coincide with the Court's ruling or even the findings of AG Kokott, since the Directive is not in any way concerned with the issue of the hypothetical duty for the Member State of the receiving company to grant loss relief in case no permanent establishment were to remain in the Member State of the transferring company, only providing under which circumstances losses incurred in the Member State of the transferring company should be offset against the profits of the permanent establishment remaining in that Member State.

[562] With regards to the *A Oy* case, AG Kokott was of a different opinion, having argued that, in the context of a merger, losses cannot be properly considered as "final", since such an operation is the consequence of a deliberate decision by the companies involved and because accepting that, after a cross-border merger, the subsidiary's losses should be relieved at the level of the receiving company would imply accepting that the companies involved had the right to freely choose where to claim relief for the losses, thus going against what the Court had previously considered inadmissible in cases such as *Lidl Belgium*.

[563] Velde, I.V., *How does the CJEU's case law on cross-border loss relief apply to cross-border mergers and divisions?*, cited above, 143.

That been clarified, what is certain is that the Merger Directive, not unlike the Parent-Subsidiary Directive and the Interest and Royalty Directive, is not, and is not intended to be, a comprehensive and all-encompassing piece of EU legislation, not covering all implications of cross-border corporate reorganisations, but only some "selected issues". All other issues of compatibility with European Union law that are not specifically addressed by the Directive and which may nonetheless arise in case of such a cross-border operation cannot but be solved be making reference to the fundamental freedoms and the principle of non-discrimination, as clarified by the Court in it's *A Oy* judgement.

5. The Anti-Tax Avoidance Directive.

Another piece of the puzzle was recently added to the dialectical relationship between "source countries" and "residence countries" in the context of the European Union secondary law in the field of direct taxation, as a result of the new level of attention being paid to the topic of the prevention of tax evasion and tax avoidance in the international context[564].

On the point of the preferable criteria for the allocation of taxing powers amongst Member States, the solutions proposed by the Commission, at least as far as prevention of tax avoidance is concerned, seemed, to a certain extent, to favour the interests of the source country, as a consequence of the need for taxation to effectively reflect the actual reality of the business activities. More in detail, in fact, the Commission had stated that "*a new approach to corporate taxation is needed in the EU, which should be driven by the following objectives: re-establishing the link between taxation and where economic activity takes place, and ensuring that Member States can correctly value corporate activity in their jurisdiction*"[565] and that "*companies that benefit from the Single Market and generate profits there should pay tax on those profits within the EU, at the place of activity*"[566].

[564] The European Council has welcomed the work of the OECD Base Erosion and Profit Shifting initiative in its conclusions of 13-14 March 2013 and 19-20 December 2013, after which the Commission, in its communication of 17 June 2015, set out an action plan for fair and efficient corporate taxation in the European Union. The final report on the fifteen OECD Actions against Base Erosion and Profit Shifting were released to the public on 5 October 2015.

[565] European Commission, COM (2015) 302 final, Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, *A fair and efficient corporate tax system in the European Union: 5 key areas for action*.

[566] European Commission, COM (2016) 198 final, *Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches*. It should also be noted that the Commission had voiced similar opinions in other cases where it had highlighted the need for a higher degree of symmetry between the country where tax is levied and the place where the underlying income is actually earned. For example, in 2014 the Code of Conduct for Business Taxation Group agreed that preferential regimes, such as patent boxes or other fiscal advantages linked to R&D activities, should

A considerable number of authors has argued that this approach would appear to be based on the - somehow misguided - idea that global profits of multinational enterprises have an actual and clearly identifiable "source" and can easily be fragmented and apportioned amongst the taxing jurisdictions concerned. However, as already highlighted in the first chapter of the research, this assumption is not necessarily true, since it can be particularly complicated, without going to further details that escape the scope and purpose of this study, to identify the actual source of the income.

On the point, while highlighting the "*urgent need to challenge […] corporate tax abuse and to review corporate tax rules in order to better tackle aggressive tax planning*", the European Commission itself has acknowledged that, given that "*business models and corporate structures have become more complex, making it easier to shift profits*", it is now "*more difficult to determine which country is supposed to tax a multinational company's income*"[567].

The elaboration of such principles has led to the recent adoption of Council Directive 2016/1164/EU, also known as the "Anti-Tax Avoidance Directive"[568], which constitutes part of a larger "Anti-Avoidance Package" intended to address a series of issues connected to the OECD "BEPS Project"[569-570].

It should be noted at the outset that, like for all of the other pieces of EU secondary law which have been described above, the scope of application of the Directive is limited to corporations, as, pursuant to its Article 1, "*this Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country*".

The Anti-Avoidance Directive aims at establishing common rules against tax avoidance affecting the functioning of the Internal Market[571]. In other words, the main

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be based on the so-called "modified nexus approach" and, in its Communication on "*A fair and efficient corporate tax system in the European Union: 5 key areas for action*", COM (2015) 302 final, the Commission stated once again that there should be a direct link between the tax benefits and the underlying R&D activities.

[567] European Commission, COM (2015) 302 final, Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, *A fair and efficient corporate tax system in the European Union: 5 key areas for action*.

[568] The Directive came into force on 8 August 2016 and Member States are expected to implement its provisions within their domestic legal orders within 31 December 2018, exception made for the articles of the Directive concerning exit taxation (Article 5), which must be implemented within 31 December 2019, and for the provisions regarding interest deductibility (Article 4), concerning which, in case a Member State has already enacted domestic provisions on the point which could be considered as equally effective in countering base erosion and profit shifting, it is allowed to apply the same rules until 1 January 2024.

[569] Together with the 2015 Action Plan for Fair and Efficient Corporate Taxation intended to re-launch a proposal for a CCCTB in the context of the European Union, a recommendation on tax treaties, a revision of the Directive on Administrative Cooperation and a Communication on an External Strategy for Effective Taxation.

[570] Moscovici, P., *Tough measures needed to reform tax on corporate profits*, in EC Tax Review, 2016, 1, 2,.

[571] Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the Internal Market, COM(2016) 26 final.

purpose of the Directive, containing specific measures operating in different fields of direct taxation, including, but not limited to, rules on limits for the deductibility of interests, exit taxation, switch-over clauses, a general anti-abuse clause and CFC legislation, is to determine minimum anti-abuse standards enabling Member States to counter situations in which taxpayers, especially of a corporate nature, take advantage of the disparities amongst the different domestic tax systems in the Member States[572].

Very few pointers may indeed be derived from the provisions of the Anti-Tax Avoidance Directive that might actually be relevant for the purposes of the design of an overall model of allocation of taxing powers amongst Member States. The Directive, in fact, is essentially aimed at solving very specific problems with an approach that cannot be easily reconciled with a more encompassing view of the structure of Member States' tax systems.

However, even though the Directive, like any other piece of EU secondary law in the field of direct taxation, does not aim at establishing any sort of overall allocation of taxing powers between countries in the Internal Market, it is undoubtedly true that the new rules cannot but have consequences on the exercise, and on the extension, of the Member States' taxing powers in the field of corporate taxation, especially since, as has been highlighted in the previous chapter of the research[573], anti-avoidance provisions often entail some sort of extraterritorial exercise of taxing powers on the part of countries: this is the case, for example, of CFC regimes or of regimes revolving around on the "deemed residence" of corporations, which ultimately constitute an extension of worldwide taxation covering foreign items of income accruing on non-resident subjects that would normally escape the fiscal jurisdiction of the country levying the tax. It is, therefore, interesting, for the purposes of the present research, to examine how the Directive deals with the question of the allocation of the Member States' taxing powers between "residence countries" and "source countries" with regards to the taxation of foreign items of income.

The Preamble of the Directive contains a general statement according to which "*the current political priorities in international taxation highlight the need for ensuring that tax is paid where profits and value are generated*". Some commentators have interpreted this statement as the affirmation of a hypothetical preference of the EU legislature for a territorial tax model based on taxation at source. This thesis, however, would appear to

[572] Navarro, A., Parada, L., Schwarz, P., *The proposal for an EU Anti-avoidance Directive: some preliminary thoughts*, in EC Tax Review, 2016, 3, 117; Ginevra, G., *The EU Anti-Tax Avoidance Directive and the Base Erosion and Profit Shifting (BEPS) Action Plan: necessity and adequacy of the measures at EU level*, in Intertax, 2017, 2, 120.
[573] See Chapter 2, paragraph 7.

be substantially contradicted by the subsequent provisions of the Directive, which, as we will see, show a certain tendency for favouring worldwide taxation in the Member State of residence and also a certain degree of tolerance towards some examples of extraterritorial exercise of taxing powers.

Having established all of the above, the most interesting parts of the Proposal at issue, at least for the purposes of the present study and also in light of the analysis conducted in the previous chapter of the research, are those dealing with exit taxation and CFC legislation.

5.1. Exit taxation.

As far as exit taxation is concerned, Article 5 of the Directive provides a common framework for taxation of capital gains generated in the territory of the Member State of origin at the time of the taxpayer's emigration and of certain cross-border transfers of assets within the European Union or to a third country as well, in so far as the Member State of emigration loses the right to tax such gains as a consequence of the transfer.

More specifically, Article 5 provides that Member States shall impose an exit tax in case of cross-border transfers of residence, in order to prevent EU citizens (individuals and companies) from moving their fiscal residence to another tax jurisdiction without paying taxes on unrealised capital gains. In case the taxpayer were to move its residence to another EU Member State, that taxpayer would be subject to tax on an amount equal to the market value of the transferred assets, at the time of emigration, less their value for tax purposes, insofar as the Member State of departure no longer has the right to tax the transferred assets because of said transfer[574].

[574] Pursuant to Article 5 of the Directive, immediate taxation is triggered if "*a) a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country in so far as the Member State of the head office no longer has the right to tax the transferred assets due to the transfer; b) a taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer; c) a taxpayer transfers its tax residence to another Member State or to a third country, excepts for those assets which remain effectively connected with a permanent establishment in the first Member State; d) a taxpayer transfers the business carried on by its permanent establishment from a Member State to another Member State or to a third country in so far as the Member State of the permanent establishment no longer has the right to tax the transferred assets due to the transfer*". A similar provision has also been included in the 2016 proposal for a Council Directive on a Common Corporate Tax Base put forward by the European Commission, COM(2016) 685 final of 25 October 2016. Article 29 of the proposal ("*Exit taxation*"), in fact, provides that "*an amount equal to the market value of the transferred assets, at the time of exit of the assets, less their value for tax purposes, shall be treated as accrued revenues*" in similar circumstances as those listed above and that "*the Member State to where the assets, tax residence or the business carried on by a permanent establishment are transferred shall accept the value established by the Member State of the taxpayer or of the permanent establishment as the starting value of the assets for tax purposes*".

That being established, the provision of the Directive, broadly reflecting the well-established Court of Justice's case law in the field of exit taxation[575], secures the right of a taxpayer to defer, by way of instalments, the payment of exit charges in case of transfers or migrations within the European Union[576], whereas, in case the taxpayer were to move its residence to a third country, Member States shall provide for the immediate recovery of the entire tax due on unrealised gains[577].

Coming to the main purpose and object of the research, it should be noted that exit taxation regimes are not easily reconciled with the analysis of the allocation of taxing powers amongst countries in terms of the dialectical relationship between "source country" and "residence country" and, therefore, in terms of the trade-off between worldwide taxation and territorial taxation. Thus, no relevant pointers on the hypothetical preference, on the part of the European Union legislature, for one of the two models can be found in the Directive's provisions on exit taxes.

Nonetheless, the Anti-Tax Avoidance Directive's rule on exit taxation might perhaps be considered as the first actual example, enshrined in a piece of EU secondary legislation, of the idea of an entirely new and integrated territorial dimension applying in the context of the Internal Market for the purposes of direct tax law (at least as far as corporate income taxation is concerned).

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[575] Reference is made to judgements such as *National Grid Indus*, *Commission v. Portugal*, *DMC* and *Verder*, all mentioned and examined in the previous chapter of the research (see Chapter II, paragraph 8), even though the provision seems to lack any explicit reference to the "temporal component" of territoriality as mentioned in *National Grid Indus*.

[576] Pursuant to paragraph 2 of Article 5 of the Directive, "*a taxpayer shall be given the right to defer the payment of an exit tax […] by paying it in instalments over five years, in any of the following circumstances: a) a taxpayer transfers assets from its head office to its permanent establishment in another Member State or in a third country that is party to the Agreement on the European Economic Area (EEA Agreement); b) a taxpayer transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or a third country that is party to the EEA Agreement; c) a taxpayer transfers its tax residence to another Member State or to a third country that is party to the EEA Agreement; d) a taxpayer transfers the business carried on by its permanent establishment to another Member State or a third country that is party to the EEA Agreement*", provided, however, that the possibility of a deferral shall apply to third countries that are parties to the EEA Agreement only "*if they have concluded an agreement with the Member State of the taxpayers or with the Union on the mutual assistance for the recovery of tax claims, equivalent to the mutual assistance provided for in Council Directive 2010/24/EU*". In these cases, nonetheless, the Member State of emigration may, under certain circumstances, charge interest in accordance with its national law and may also request the issuance of a bank guarantee (in contrast with the Court's ruling in *DMC*, where the Luxembourg Judges held that the requirement of a bank guarantee constitutes a restriction of the fundamental freedoms that cannot be justified without prior assessment of the risk of non-recovery. More in detail, the Court, in the *DMC* judgement, stated that Member States are only permitted to request a guarantee in respect of the payment of exit taxes "*on the basis of the actual risk of non-recovery of the tax*", with an assessment having to be made on a case-by-case basis: when it is established that there is no particular risk of non-recovery, Member States are generally prevented from requiring guarantees. Furthermore, an interpretation of the Court's *Commission v. Denmark* case (where the Court ruled that the provision of guarantees in relation to an exit tax is disproportionate when the taxpayer concerned continues to be a resident of its Member State of origin) may hint to the fact that the above-mentioned risk might be considered as lacking in a situation where the taxpayer concerned remains a resident of the Member State of origin, since that Member State, in this case, would enjoy alternative options to guarantee the safeguard of its tax claims. On the point, see Potgens, F.P.G., van Os, P., Duran, P.H., et al., *The compatibility of exit tax legislation applicable to corporate taxpayers in France, Germany, Italy, the Netherlands, Portugal, Spain and the United Kingdom with the EU freedom of establishment*, cited above, 2, 165; Navarro A., Parada, L., Schwarz, P., *The proposal for an EU Anti-avoidance Directive: some preliminary thoughts*, cited above, 121.

[577] Pinetz, E., Schaffer, E., *Exit taxation in third-country situations*, in European Taxation, 2014, 3, 10.

The functioning itself of a rule on exit taxation, in fact, revolves around the idea of a "relevant territory", exiting which taxation is triggered on the emigrating taxpayer as a consequence of the emigration[578]. In other terms, whenever a (corporate) subject (or certain assets of the corporate subject) lose their connection to the territory of the Member State where said subject resides, the Member State has the right to levy taxes on the accrued but still unrealised capital gains related to that corporate subject (or to the assets concerned). This rule would appear to be grounded on a "traditional" application of fiscal territoriality.

However, through the implementation of the new norm on exit taxation, a company's migration from a Member State to establish its seat in another Member State (or the transfer of certain assets from a Member State to another by a corporation) - being it that the corporate subject (taxpayer) remains within the "Internal Market territory" - becomes fiscally neutral for the emigrating taxpayer, which would enjoy a deferral of its tax liability arising from the emigration. Whereas, on the other hand, such "neutrality" would not be granted in case of migration to a third country not constituting part of the Internal Market.

In other terms, the consequence of this mechanism is that, as far as exit taxation is concerned, the relevant territorial dimensions shifts from a "compartmentalised view", in which the territory of each single Member State is considered as a monad, to a broader and integrated vision at the level of the entire Internal Market: the relevant territory, within the borders of which neutrality- or, better said, the highest possible level of neutrality - is granted, becomes the territory of the Internal Market. Which implies an entirely new and integrated dimension of territoriality, which refers to a territory that ultimately coincides with the EU Internal Market[579].

It could be argued that this kind of view is not entirely new as far as secondary EU law on direct taxation is concerned.

A similar perspective and functioning could, in fact, actually be found in the provisions of the Merger Directive as well[580], even though, in that case, the element of the "broadening" of the territorial dimension was considerably less evident, mainly because of the fact that the Merger Directive essentially applies to situations where two subjects (two taxpayers) are involved, i.e. the transferring/merging company and the receiving

[578] This is the reasoning followed by the Court of Justice in its *National Grid Indus* decision, where, in order to conclude that the relevant provisions gave rise to a restriction of freedom of establishment, the Judges held that the transfer of the seat abroad should be compared to domestic situations in which a company transfers its seat within the territory of its Member State of establishment.

[579] More on the point of exit taxation will be seen in the next chapter of the research, when talking about the provisions of the new Anti-Tax Avoidance Directive, at paragraph 5.

[580] As also noted above, at paragraph 4.

company located in another Member State, each one of which has/had its own fiscal liability in its Member State of establishment, which naturally applies its tax laws to its fiscal residents. With regard to exit taxation, on the contrary, the tax liability being considered is only one, as only one taxpayer is involved in the relevant cross-border movement, which makes the exit taxation case "exceptional", being it an example of an actual coordination of concurring taxing powers exercise by two different Member States on the same subject: the same (corporate) subject emigrates and moves across the Internal Market as it was a single territory, with no fiscal consequences (immediately) arising as a direct consequence of such movement.

5.2. Controlled Foreign Company regimes.

Moving on to the other provisions of the Directive which may be relevant for the purposes of the present research, Articles 7 and 8 of the Directive concern CFC regimes, allowing the tackling of base erosion and profit shifting phenomena through the reattribution of the income of a foreign company, usually if located in a low-tax jurisdiction, and making it taxable in the fictitious "home jurisdiction". CFC regimes, therefore, basically revolve around the extension of worldwide taxation also towards subjects and/or items of income that should generally escape the tax jurisdiction of the home country[581]. According to the Preamble of the Directive, in fact, through this provision, the EU legislature aim at "*re-attributing the non-distributed income of a low-taxed controlled subsidiary to its parent company*", which "*becomes taxable on this attributed income in the State where it is resident for tax purposes*".

As we will also see in the following chapter of the research[582], a considerable number of Member States' tax systems already embed such rules but, however, their application varies so much that taxpayers may take advantage of these differences in order to circumvent the application of the rules[583]. It was thus considered necessary to provide Member States with a common pattern for the implementation of these regimes, in order to grant their extensive and uniform application in the Internal Market.

Article 7 of the Directive provides that, where a Member State treats an entity or permanent establishment as a "controlled foreign company"[584], that Member State is

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[581] For a clear description and analysis of the functioning and mechanisms underlying CFC regimes, see Cipollina, S., *Profili evolutivi della CFC legislation: dalle origini all'economia digitale*, in Rivista di Diritto Finanziario e Scienza delle Finanze, 2015, 3, 356.

[582] See Chapter IV, paragraph 5.

[583] On the point, see the Chapter IV of the research, paragraph 5.

[584] Pursuant to paragraph 1 of Article 7, Member States shall treat an entity or a permanent establishment whose profits are not subject to tax or are exempt from tax according to their tax systems as a "controlled foreign

allowed to attribute part of the non-distributed income of such foreign company to the resident taxpayers controlling it, with that attribution being made, pursuant to Article 8, "*in proportion to the taxpayer's participation in the entity*".

In this case, the Directive provides EU Member States with two alternatives between which they must choose. These two alternatives are broadly based on the traditional distinction, traced by legal scholarship, between two different "categories" of CFC legislation[585]: the so-called "transactional approach", aimed only at the attribution, on the ground of a rule of transparency, of the controlled foreign company's passive income to the parent company, and the so-called "jurisdictional approach", which, on the other hand, aims at subjecting to taxation the entire income accrued on the controlled company established in a low-tax jurisdiction[586].

Therefore, Member States, on one hand, may choose to include in the tax base of the resident holding subject the non-distributed income accrued to the entity or permanent establishment "*arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage*", it being specified that, for the purposes of the Directive, an arrangement is regarded as "non-genuine" "*to the extent that the entity or permanent establishment would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income*".

In this case, pursuant to Article 8, the Member State shall include the foreign income in the tax base of its resident taxpayer only up to the amounts "*generated through assets and risks which are linked to significant people functions carried out by the controlling company*", applying the arm's length principle.

On the other hand, as an alternative, the Member State of the holding company may choose to include in the tax base of the resident subject holding the controlled foreign company only the non-distributed income of the entity or the income of the permanent establishment having a "passive nature" (i.e. interest and other income generated by financial assets, royalties and other income generated from intellectual

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company" for the purposes of the Directive if a) a corporate taxpayer liable to tax in that same Member State "*holds a direct or indirect participation of more than 50 percent of the voting rights, or owns directly or indirectly more than 50 percent of capital or is entitled to receive more than 50 percent of the profits of that entity*" and b) "*the actual corporate tax paid on its profits by the entity or permanent establishment is lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment*".

[585] This distinction is also mirrored in the OECD elaboration on the point of CFC legislation. On the point, see, amongst others, Sandler, D., *Tax treaties and Controlled Foreign Company legislation: pushing the boundaries*, Amsterdam, 1998, *passim*; Maisto, G., Pistone, P., *A European model for Member States' legislation on the taxation of controlled foreign subsidiaries (CFCs)*, in European Taxation, 2008, 10, 503.

[586] For instance, the Italian CFC regime adheres to the second category.

property, dividends and income from the disposal of shares, income from financial leasing, income from insurance, banking and other financial services, etc.)[587].

In this case, an exemption from the regime shall be granted if the relevant controlled foreign company carries on a "*substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances*", but, in case that controlled foreign company is located in a country which is not a member of the European Economic Area Agreement, Member States are at liberty to decide not to apply this exemption.

Furthermore, pursuant to Article 8 of the Anti-Avoidance Directive, in case the Member State of residence of the holding company chooses to implement the "passive income approach" described above, then the passive income to be included in the tax base of the resident taxpayer shall be calculated in accordance with the tax laws of the Member State of residence of that taxpayer[588].

Irrespective of which of the two options the Member States of residence of the controlling company choose to follow, they, pursuant to paragraphs 5 an 6 of Article 8, shall have to grant relief for the taxes already paid by the parent company on the profits of the controlled foreign company concerned when an actual distribution of such profits is made, or when the parent company disposes of its shares in the controlled company. Furthermore, Member States, pursuant to Article 8, paragraph 7, shall grant the parent company a deduction of the tax paid by the entity or permanent establishment in its state of tax residence. Said deduction, which practically amounts to a tax credit, shall be calculated in accordance with the national tax law of the Member States of residence of the controlling company.

It should be noted that, on the point, the Preamble of the Directive clearly states that "*where the application of those rules* [i.e. CFC rules] *gives rise to double taxation, taxpayers should receive relief through a deduction for the tax paid in another Member State or third country*" and that CFC rules "*should not only aim to counter tax avoidance practices but also avoid creating other obstacles to the market, such as double taxation*".

The first commentators of the Directive have highlighted that these provisions would seem to be in line with the Court of Justice's jurisprudence on CFC rules and anti-avoidance provisions and, in particular, with the "*Cadbury Schweppes* doctrine", requiring the controlled company at issue to be engaged in a "*substantive economic*

[587] It being specified, however, that, pursuant to paragraph 3 of Article 7, the Member State concerned "*may opt not to treat an entity or permanent establishment as a controlled foreign company under paragraph 1 if one third or less of the income accruing to the entity or permanent establishment*" can be considered as income of a passive nature.
[588] Paragraph 1 of Article 8 specifies that "*losses of the entity or permanent establishment shall not be included in the tax base but may be carried forward, according to national law, and taken into account in subsequent tax periods*".

activity" which must not be "*wholly artificial*" in order for the CFC provision not to apply[589]. It has also been noted that the CFC regime, from the point of view of the Court's case law, can be seen as an "allocation of taxing rights rule", which further justifies rules such as those embedded in Articles 7 and 8 of the Directive[590]. Even more so if we consider that, as highlighted in the previous chapter of the research, according to the more recent Court's judgements on the point, a measure concerning the allocation of taxing powers amongst Member States and also aimed at preventing the risk of tax avoidance can be considered as proportionate even if not specifically addressed at "wholly artificial arrangements".

As they are aimed at preventing the possible abuses connected to the transfer of profits to low-tax jurisdictions, CFC regimes are, by their nature, a clear expression of capital export neutrality and of a tax model based on a worldwide structure. As already highlighted above, and in the previous chapter of the research, CFC regimes constitute one of the clearest example of worldwide taxation.

Therefore, confirming the most recent trends of the Court of Justice's case law on the point, the Directive explicitly allows Member States to derogate from a rigorously territorial structure of the extension of their taxing powers in favour of the application of worldwide liability to tax to items of income (and taxpayers) that are not directly connected to the territory of the taxing country. Thus *de facto* allowing an extraterritorial exercise of taxing powers on the part of the Member State of residence of the parent company.

6. Concluding remarks: general tendencies and the missing pieces of the puzzle.

Many have argued that it would be, to a certain extent, "naïve", as of today, to think of an "authentically European corporate income tax" aimed at raising common resources for the Union's coffers and that it would be preferable, and also more easily attainable, to limit the intervention of the EU legislature only to preventing, eliminating or alleviating the so-called "negative tax externalities", such as the prejudicial effects of tax avoidance, base erosion, profit shifting and fictitious transfers of residence and/or income to territories located outside the European Union[591].

[589] Ginevra, G., *The EU Anti-Tax Avoidance Directive and the Base Erosion and Profit Shifting (BEPS) Action Plan: necessity and adequacy of the measures at EU level*, cited above, 129.
[590] Dourado, A.P., *The EU Anti-Avoidance Package: moving ahead of BEPS?*, in Intertax, 2016, 6, 440.
[591] Garbarino, C., *Harmonisation and coordination of corporate taxes in the European Union*, in EC Tax Review, 2016, 5-6, 277. The Author highlights, in particular, from a "diachronic" point of view, the "failure" of any EU fiscal

The picture emerging from the overall analysis of EU secondary law in the field of direct taxation is somehow fragmented and, in any case, partial, which makes it particularly difficult to draw general principles and criteria that might be considered as suitable to guide Member States in the interpretation of the positions and tendencies of European Union law on the point of the allocation of taxing powers amongst member States in the dialectical relationship between "source taxation" at "residence taxation" and of hypothetical preferences for one of the two models.

On one hand, in fact, it is certainly true that the Directives examined above give rise, to a certain extent, to a "prototype" of an overall allocation of taxing powers at the level of the Internal Market, establishing whether the Member State of residence or the Member State of source should have priority to tax certain cross-border items of income and, consequently, which of the two countries should eliminate possible issues concerning double taxation. On the point of double taxation, furthermore, it should be noted that, notwithstanding the absence of a specific prohibition in the Treaties and in the jurisprudence of the Court of Justice as well, double taxation is expressly considered by the Directives as an undesirable consequence of the "parallel exercise of taxing powers" on the part of the Member States and a potential obstacle for the integration and the proper functioning of the Internal Market and thus should be eliminated.

On the other hand, the allocation of taxing powers enacted by the Directives is partial, being it inherently sectorial. Directives apply only to corporations and only to certain items of the overall income of such corporations (dividends, interest, royalties, etc.), as they are aimed at solving specific problems at not at providing an overall design encompassing a solution on a larger scale.

Having established all of the above, what can be stated with a considerable level of certainty is that EU secondary law shows a global tendency towards the implementation of fiscal structures based on worldwide taxation and on priority to tax cross-border items of income being granted to the country of residence of the taxpayer.

This is what may be derived, for instance, from the analysis of the Parent-Subsidiary Directive, also as interpreted and applied by the Court of Justice of the European Union. In fact, even though the analysis of the Parent-Subsidiary Directive has not shown a clear preference, on the part of the EU legislature, for one of the two traditional tax models, the provisions of said Directive being substantially "neutral" on

measure which has aimed at such a purpose, from the first steps taken in 1960s to the current "soft law" approach adopted by the Commission. Of the same opinion, see also Esson, A., *Harmonisation of direct taxation in the European Community: from Neumark to Ruding*, in Canadian Tax Journal, 1992, 600; Eden, S., *Corporate tax harmonisation in the European Community*, in British Tax Review, 2011, 6, 627; Cerioni, L., *The quest for a new corporate taxation model and for an effective fight against international tax avoidance within the EU*, in Intertax, 2016, 463.

the point, this apparent "interchangeability" of tax models seems to have been somehow limited and "steered" by the Court of Justice, as the analysis of the *Bosal Holding* judgement has demonstrated, with a consequent derogation to tax territoriality.

A more definite answer can be drawn from the analysis of the Interest and Royalty Directive, which shows a substantial preference for a fiscal system based on taxation in the Member State of residence.

This tendency would appear to have been somehow confirmed, even though for different purposes, by Articles 7 and 8 of the Anti-Tax Avoidance Directive on CFC legislation, where the EU legislature, picking up from the well-established Court's case law on the point, expressly allows, for the specific purpose to prevent tax avoidance through profit shifting and base erosion, forms of extraterritorial exercise of taxing powers on the part of the Member States: Member States may, thus, extend their fiscal jurisdiction even to cover items of income which cannot be considered as effectively linked to their territory, neither subjectively or objectively.

However, it is also true that this statement might as well be read in an opposite sense, i.e. as the demonstration that EU legislature does not allow departures from a tax model based on territoriality apart from "extreme cases" that may justify an exception to this general rule, one of which would be the implementation of CFC regimes. According to the Anti-Tax Avoidance Directive, such regimes would, in fact, be applicable only to exceptional circumstances, i.e. constructions that can be defined as "wholly artificial arrangements", and/or only to certain types of income (passive income).

Notwithstanding all of the above and the considerable difficulty to draw general conclusions from very specific and sectorial provisions, the analysis of EU secondary law on direct taxation has nonetheless led to interesting results concerning a new possible "territorial dimension" which might be relevant, in a future perspective, from the point of view of a more integrated and functioning EU Internal Market.

Reference is made, more specifically, to the provisions of the Merger Directive and especially to Article 5 of the Anti-Avoidance Directive on the point of exit taxation. These provisions, as highlighted above, can be considered as the first "rehearsal" of a shift from a "compartmentalised view", where the territory of each single Member State is considered as a "monad" for the purposes of direct taxation in the EU, to an integrated vision of a new "territory" from an overall perspective and ultimately coinciding with the borders of the Internal Market.

The change of perspective on exit taxation measures is evident: national tax systems on exit taxation serve (or used to serve) national fiscal and financial interests; in

a context such as the European Union, deprived of any direct actual taxing power, a legislation on exit taxation can only be justified as a limit to the exercise of the Member States' taxing powers or with a view to the prevention of abusive behaviours on the part of taxpayers[592].

It is, however, abundantly clear that the road ahead is still considerably long, especially if, as declared by the Commission and recognised by the Court, the ultimate purpose of the European Union legal order should be the attainment and implementation of a properly functioning and integrated Internal Market.

One of the topics which has not been included within the scope of secondary EU law yet is cross-border loss relief, even though, as has been demonstrated through the analysis of the Court's case law conducted in the previous chapter of the research, the issue has constituted one of the most crucial problems for the actual integration of the Internal Market, with considerable reflections on the question of the relationship between source taxation and residence taxation[593].

Acknowledging that the allocation of profits and losses amongst Member States constitutes a major policy issue and that the Court of Justice has decided many cases on cross-border migrations of losses and profits, holding that they are able to affect the balanced allocation of taxing powers amongst Member States, the Commission, in 2005, proposed a solution for small and medium-sized enterprise, suggesting that Member States should allow them to compute their taxable profits according to the tax rules of the Member State of residence of the parent company or of the head office[594]. According to this proposal, each Member State would then tax, at its own corporate tax rate, its share of the profits.

This action was subsequently upstaged, in 2011, by the proposal for a Common Consolidated Corporate Tax Base (CCCTB). The proposal started from the assumption that residence and source countries unilaterally protect their tax bases from erosion and

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[592] Di Pietro, A., *Past and perspectives of exit tax*, in European Tax Studies, 2009, 1.

[593] On the point, in 1990 the Commission had adopted a proposal for a directive on the accounting of the losses suffered by permanent establishments and subsidiaries located in different Member States from that of establishment of their head office or parent company: see Commission Proposal COM/1990/595, 24 January 1990. The proposed directive would have envisaged two different methods in order to allow companies to take into account the losses suffered by their foreign permanent establishments: an imputation method, based on the granting of a credit for taxes paid abroad, and an exemption method, allowing for the permanent establishment's losses to be deducted from the head office's profits. On the point, see Carinci, A., *Stabile organizzazione e circolazione transnazionale delle perdite*, in Diritto e Pratica Tributaria, 2014, 5, 10855. The proposal was then withdrawn in 2004. In 2006 the Commission put forward a Communication concerning the tax treatment of losses for cross cross-border business activities, acknowledging the considerable differences amongst the domestic tax systems of the Member States on the point and calling for the introduction of new and effective systems suitable to guarantee cross-border loss relief in the context of the Internal Market: see Commission Communication COM(2006) 824, 19 December 2006.

[594] European Commission, COM (2005) 702, Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, *Tackling the corporation tax obstacles of small and medium-sized enterprises in the Internal Market - outline of a possible home state taxation pilot scheme*.

shifting of profits and losses through uncoordinated strategies that are liable to create disparities, discriminations and restrictions.

On 16 March 2011, the Commission put forward its proposal for a directive on a Common Consolidated Corporate Tax Base[595], whose functioning mechanisms would basically revolve around a sort of global formulary apportionment[596]. The overall goal of the CCCTB proposal is to enhance intra-EU cross-border investment and fair competition in the Internal Market, while its main fiscal purpose would be to enhance efficiency and simplicity of corporation taxes in the European Union and to reduce market distortions caused by corporate taxation.

The CCCTB mechanism would essentially allow Member States to determine the taxable base of groups of companies across the European Union's territory according to uniform rules, thus enabling either cross-border offsetting of profits and losses of different subsidiaries located in different Member States or cross-border offsetting of profits and losses of head office and braches established in different Member States. This mechanism would lead to the determination of the consolidated corporate tax base, which would then be shared amongst the Member States where the different group units are located (or amongst the Member State where the head office is located and the Member States where the single permanent establishments are located) according to a pre-determined formula based on elements such as capital, assets and labour.

The essential idea underlying the CCCTB is based on an implicit acknowledgement of the fact that the harmonisation of the corporate tax base would arguably solve a series of complicated issues concerning the allocation of taxing powers amongst Member States, ultimately favouring the activity of multinational groups in the European Union and taking a step towards a more integrated Internal Market[597].

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[595] Commission Proposal for a Council Directive on a Common Consolidated Corporate Tax Base addressed to the Council of the European Union, the European Economic and Social Committee and the European Parliament, COM(2011)121. The legal basis for this proposal is Article 115 TFEU on the approximation of national rules directly affecting the establishment or the functioning of the Internal Market. For some comments on the first CCCTB proposal, see, amongst others, O'Shea, T., *The Common Consolidated Corporate Tax BASE (CCCTB). Issues for Member States opting out and third countries: a critique and some in-depth analysis*, in EC Tax Journal, 2008, 1; Cerioni, L., *The Commission's proposal for a CCCTB Directive: analysis and comment*, in Bulletin of International Taxation, 2011, 515; Vascega, M., Van Thiel, S., *The CCCTB proposal: the next step towards corporate tax harmonisation in the European Union?*, in European Taxation, 2011, 374; Pistone, P., *Double taxation: selected issues of compatibility with European law, multilateral tax treaties and CCCTB*, in Rust, A. (ed.), *Double taxation within the European Union*, Alphen aan den Rijn, 2011, 187; Cerioni, L., *Postponement of the Commission's Proposal for a CCCTB Directive: possible ways forward*, in Bulletin for International Taxation, 2010, 2, 98.

[596] It should be noted that global formulary apportionments are generally rejected by the OECD because they are considered to be too complicated to implement, entailing risks of different interpretations and applications of their criteria, political and administrative complexities which could lead to high costs and are essentially based on arbitrary elements. For an overview of the most recent tendencies of the debate between "source taxation" and "residence taxation", see the first chapter of the research, at paragraph 4.

[597] Aujean, M., *Le fonti europee e la loro efficacia in materia tributaria, tra armonizzazione, coordinamento e concorrenza fiscale leale*, cited above, 25.

The purpose of the CCCTB is admittedly quite ambitious. However, objections have been raised from the very beginning of the process for its approval. Member States, for example, have voiced some concerns on whether the proposal was compatible with the principle of subsidiarity on which the distribution of competences between the Union and national parliaments is based[598]. This explains, at least in part, why the works on the proposal have reached a substantial halt.

The Commission acknowledged the unlikeliness of a unanimous approval of the CCCTB Proposal as originally envisaged in 2011 in its entirety, without what the Commission now called a "staged approach". Therefore, the Commission, in its 2015 Action Plan[599], advocated a "step-by-step approach" to the topic of the Common Corporate Consolidated Tax Base, suggesting that work on the aspects linked to consolidation be postponed until agreement is secured on a mandatory (and no longer optional) set of rules for the common tax base. The 2016 Proposal is thus limited to the rules for the calculation of the corporate tax base of companies across the Internal Market, whereas consolidation is envisaged to be addressed in a separate proposal for a directive, which is set to be put forward and examined only after a consensus has been reached, at political level, on the elements of the common corporate tax base.

It should also be noted that, while the regime provided for by the original CCCTB proposal was of a merely optional nature, since it did not force companies with purely domestic business activities to adhere to the regime, the new CCCTB proposal entails a regime that is no longer optional, at least for multinational groups.

The explanatory memorandum annexed to the 2016 CCTB Proposal highlights that the "mismatches" that are likely to arise "*in the interaction between disparate national corporate tax regimes*" generate "*risks of double taxation and double non-taxation and thereby distort the functioning of the Internal Market*". It follows that, since "*Europe's priority today is to promote sustainable growth and investment within a fair and better integrated market, a new framework is needed for a fair and efficient taxation of corporate profits*". Ultimately, therefore, the CCCTB is supposed to "*contribute to the elimination of obstacles which create distortions that impede the proper functioning of the Internal Market*".

Starting from these assumptions, the Commission argues that "*the CCCTB features as an effective tool for attributing income to where the value is created*" and it would do so by

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[598] Pistone, P., *Double taxation: selected issues of compatibility with European law, multilateral tax treaties and CCCTB*, cited above, 207; Munin, N., *Tax in troubled time. Is it the time for a Common Corporate Tax Base in the EU?*, in EC Tax Review, 2011, 3, 124; Cerioni, L., *Postponement of the Commission's proposal for a CCCTB Directive: possible ways forward*, cited above, 99.

[599] Commission Communication COM(2015) 302 on an Action Plan for a Fair and Efficient Corporate Tax System in the European Union, 17 June 2015.

way of a formula based on three factors, i.e. assets, labour and sales, which are supposed to be inherently attached to the country where companies earn their profit.

Coming to the substance of the proposal, for the purposes of the present research, it should be noted that, as already highlighted above, the declared purpose of the CCCTB regime is not in any way the drafting of a model for the homogeneous allocation of taxing powers between Member States, being it limited to the aim of reducing the administrative burden for companies, especially with regards to transfer pricing rules, and, indirectly, of regulating fiscal competition amongst countries to a higher level of transparency[600]. Indeed, the proposal aims only at the harmonisation of corporate tax bases: each Member State would still apply its own tax rates to its share of the taxpayer's tax base.

However, the proposed CCCTB directive would entail the implementation of a common corporate tax base through the entire European Union, i.e. one single set of rules for determining corporate profits for European groups of companies opting for the common system[601]: profits and losses of group companies would be aggregated into one single overall group tax base, with automatic and full cross-border loss relief and prevention of international double taxation (and also the elimination of the need to implement transfer pricing rules)[602].

More specifically, Article 41 of the new CCTB proposal provides that "*losses incurred in a tax year by a resident taxpayer or a permanent establishment of a non-resident taxpayer may be carried forward and deducted in subsequent tax years*". The 2016 Proposal, however, entails a number of limits to this faculty. First of all, the consequent reduction of the tax base as a result of the taking into account of losses from previous tax years may not result in a negative amount. Secondly, previous losses shall not be deducted if another company acquires a participation in the taxpayer concerned, which thus becomes a qualifying subsidiary of the acquirer, and there is a "*major change of activity of*

[600] Lang, M., *The principle of territoriality and its implementation in the proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, WU International Taxation Research Paper Series, 2012, 9, 2.

[601] The CCCTB system as originally proposed by the Commission would, in fact, be optional. Eligible groups of companies would have been able to decide whether or not to join this system, being also able to decide to ignore it and remain subject to the existing national rules for the determination of corporate tax bases. This option, as originally drafted, would have been a sort of "all-in option", meaning that, if a company belonging to a group would have opted for the CCCTB regime, then all of its qualifying EU subsidiaries would have been automatically subjected to the CCCTB regime as well, for at least five years.

[602] From an administrative point of view, the system would entail that a group of companies which has opted into the CCCTB regime would not have to deal with all of the different tax authorities of the Member States any more, but with only one tax authority, i.e. the "principal tax authority", meaning the tax administration of the Member Stare where the main holding company of the group is established.

the acquired taxpayer", with the discontinuance of the previous main activity of the taxpayer[603].

It goes without saying that the consolidation proposed by the Commission would concern the tax base only, or, better said, the determination of the consolidated taxable profits of the group of companies. Once determined, the consolidated tax base would be subsequently divided, according to an apportionment formula[604], amongst the Member States where single group companies are located (and subject to tax), which may, then, apply their own tax rates to the part of the consolidated tax base that has been allocated to them.

According to some, the CCCTB scheme would, thus, make it possible to consider the overall ability to pay of a group of companies, viewed in its own economic unity (despite being composed of subjects with separate legal personality), from an authentically "European" perspective, thus proportionally allocating such ability to pay to each Member State in relation to the elements on which the above-mentioned formula would be elaborated (essentially, labour, assets and sales)[605].

It has also been noted by part of the legal doctrine that the implementation of the proposed CCCTB Directive would reinforce the link between taxation and the place where profits are generated, from an overall "Internal Market perspective"[606]. Certainly the implementation of a CCCTB would allow the European Union Member States to overcome the traditional distinction between "source state" and "residence state", which would ultimately become irrelevant, at least with regard to corporate taxation and insofar as corporations located within the Internal Market.

It would, in fact, seem, at least from a theoretical point of view, that the CCCTB would entail a new kind of implementation of territorial connections between Member States and the companies' business income. The current territorial connections based mainly on the source of the income and on the residence of a company would be, at least

[603] According to Article 42 of the 2016 CCTB Proposal, the loss relief shall be given "*in proportion to the holding of the resident taxpayer in its qualifying subsidiaries*" (whereas it would be "*full for permanent establishments*") and for a limited period of time.

[604] It goes beyond the purposes and scope of the present research to dwell on the technical details of how this hypothetical global apportionment formula would work. Suffice it so say here that the proposed formula contains three apportionment criteria, all equally relevant, i.e. capital (fixed assets), labour (personnel and wages) and turnover (sales). Several Member States have objected to the presence of the asset factor in the apportionment formula, since, according to their position, it would not reflect economic reality and would favour Member States where "old industries" are located, as the formula ignores intangible and financial assets.

[605] Cerioni, L., *The never-ending issue of cross-border loss compensation within the EU: reconciling balanced allocation of taxing rights and cross-border ability-to-pay*, cited above, 277. The Author also suggested that, since the CCCTB legislation would introduce a "*fractional application of the ability-to-pay principle*", the general principle of equality would offer a strong base for the Commission to issue a piece of soft law on the proportional application of the ability-to-pay principle across the European Union's territory to all taxpayers falling outside the scope of application of the CCCTB provisions, thus developing the ability-to-pay principle into a part of the *acquis communautaire*.

[606] Garbarino, C., *Harmonization and coordination of corporate taxes in the European Union*, cited above, 282.

in part, replaced by an "economic territorial connection" based on the actual presence of a company or a group across the Internal Market[607], with, once again, a new territorial dimension covering the entire European Union. Fiscal jurisdiction would be exercised on the ground of the territorial connection between a Member State and the physical presence on its territory of the elements of a formula (assets, labour and capital).

[607] Monsenego, J., *Taxation of foreign business income within the European Internal Market*, Amsterdam, 2011, 460.

CHAPTER IV

TAXATION OF FOREIGN INCOME FROM A COMPARATIVE PERSPECTIVE: FISCAL TERRITORIALITY AND THE DEGREE OF IMPLEMENTATION OF THE PRINCIPLES AND RULES ESTABLISHED BY EUROPEAN UNION LAW

1. The comparative perspective for the integration of the Internal Market.

As highlighted in the first chapter of the research, national governments and parliaments are faced with two basic problems concerning international tax law, intended as the law governing taxation of cross-border circumstances: whether resident subjects should be taxed on their worldwide income or exclusively on income having its source within their country of residence and whether or not non-residents should be taxed on the income sourced within a country which is not their country of residence[608]. The answers given to these issues gave rise to the affirmation of two basic models of taxation: worldwide taxation and "territorial" taxation[609].

It has also been noted in previous pages of the research that, in common income tax law practice, two main connecting criteria generally operate: the "subjective" criterion based on residence, corresponding to a worldwide tax model, and the "objective" criterion based on the place where the income is produced, which corresponds to a model of taxation at source, also defined as "territorial"[610]. Countries adhering to the worldwide tax model generally implement taxes of a "personal" nature (so does Italy, for example), levying them to all of the resident taxpayers' income,

[608] See Chapter I, paragraph 4.
[609] Avi-Yonah, R.S., Sartori, N., Marian, O., *Global perspectives on income taxation law*, cited above, 150.
[610] Some authors have even argued that these criteria should be considered as actual general principles recognised by civilised nations, pursuant to Article 38 of the Statute of the International Court of Justice. Of this opinion, Garbarino, C., *La tassazione del reddito transnazionale*, cited above, 95; Melis, G., *La nozione di residenza fiscale delle persone fisiche nell'ordinamento tributario italiano*, cited above, 1034.

wherever accrued, while countries adhering to the "territorial" model levy taxes only on income which is produced within their territory (as France does, as far as corporate income tax is concerned), by applying their own sets of criteria and sourcing rules aimed at the localisation of the production of the income.

Both the above-mentioned "objective" and "subjective" criteria are declinations of the territorial connection which, according (not to internationally recognised principles or customary law, but) to common state practice, is necessary for a state to exercise its taxing powers on a certain item of income: one focuses on the source of the income rather than on which subject owns it, whereas the other focuses on the person producing or owning that income and his/her/its allegiance to a certain state[611].

This is the reason why the comparative perspective, that will be adopted in the present chapter, is functional to the completion of the present research. Such analysis will be useful in two "directions": a "horizontal" one, in order to verify how certain selected states have chosen to allocate their taxing powers and to implement the "territorial" concepts of "residence" and/or "source" in their own domestic systems; a "vertical" one, in order to verify how the choices of each single Member State analyses affect the overall possibility of reaching an effectively integrated Internal Market.

On how states decide to implement such territorial connection, in fact, revolve the actual extension of their taxing powers, the amount of the burden imposed on taxpayers and the amount of the "sacrifice" possibly being imposed on another country's taxing rights, either by way of bilateral agreements in the form of conventions against double taxation or, for European Union Member States, as a consequence of the necessary compliance with European Union law, whose primacy may be ensured by the intervention of the Court of Justice or by single pieces of secondary EU law.

The ways states implement these criteria is, therefore, crucial in the attempt to reach a hypothetical balanced allocation of taxing powers within the European Union, i.e. a hypothetical territorial allocation of taxing powers where the relevant "territory" cannot but coincide with the dimension of the entire Internal Market.

Legal scholarship has identified two main approaches to defining what constitutes "source" for the purposes of (international and domestic) tax law, i.e. the so-called "formal approach" and the so-called "substantive approach". It is generally believed that the substantive approach is more suitable to attain anti-avoidance purposes, being it more focused on concepts such as economic substance, which are not

[611] Even though, as we will see, states still envisage forms of "extraterritorial" exercise of their taxing powers, i.e. cases where the territorial connection between their territory and the items of income on which tax is levied is particularly feeble and, sometimes, even fictitious.

under the full control of the taxpayer, whereas formal criteria, being them based on "technical" tests, are more easily "steered" by the taxpayer[612]. The formal approach is usually adopted to define the source of passive income, such as interest and royalties, whereas the substantive approach is mainly adopted with concern to active income, being it focused on where the actual business activity giving rise to the income has taken place.

As we will see in the following pages, a similar distinction can be traced also with regards to the criteria on the ground of which states define which taxpayers should or should not be considered as their "residents" for fiscal purposes, with all evident consequences on the extension of such taxpayers' tax liability (limited or unlimited). The great divide, once again, is between formal criteria, such as those based on a subject being listed, for example, in the civil registry of the population or the place of incorporation of a certain company, and substantial criteria, i.e. the place of effective management of a company or the place where the individual taxpayer has his/her family and/or business ties.

However, in order to verify the actual existence of a tie with the taxing state is not sufficient to stop at the mere content of the provision which states that a certain criterion is relevant to justify the exercise of taxing powers by the state.

If we go deeper into details, we can see, for example, that there are legal orders (e.g. the United States) that consider the subjective status of citizenship as sufficient to tax the worldwide income of their taxpayers/citizens. We could also see that the rules regulating the acquisition and preservation of citizenship allow for hypothesis in which a citizen is considered as such even in absence of any actual and constant connection with the national community, thus indirectly leading to a system that taxes a "citizen" for income produced abroad even if there is no effective link with the state: the consequence would be a purely extraterritorial income tax.

The same could be also said with regards to the provisions establishing the notion of "residence", which, especially in the current context characterised by a higher level of mobility, tend to an increasing extension of the definition of "residence" for tax purposes and to put on taxpayers the burden of proof in order to demonstrate that they do not reside within a certain state and should not, therefore, be taxed on their worldwide income by that state.

The interplay between the "objective" and the "subjective" declinations of territoriality (not as a principle, but, more correctly, as a criterion) and their combined

[612] Avi-Yonah, R.S., Sartori, N., Marian, O., *Global perspectives on income taxation law*, cited above, 155.

integration in countries' tax models has led to the development of two main models, as already observed in the first chapter of the research: worldwide taxation and "territorial" taxation.

Some scholars have made and still make strong arguments advocating the application of territorial tax systems, which they view as the most efficient way to reach international tax neutrality with regards to cross-border moving of enterprises, capital and investments and to guarantee fair competition between residents and non-residents carrying out the same economic activities in the same territory and under the same market conditions[613].

The United States, the United Kingdom and Italy are examples of countries that have chosen to adhere to the "worldwide tax jurisdiction model" and, therefore, tax their residents on worldwide income from whatever source derived. On the other hand, France and the Netherlands, for example, as well as other continental European countries, have implemented, at least in part, a fundamentally territorial tax system, thus taxing residents and non-residents only on income derived from sources within their respective taxing jurisdictions.

However, whereas, on one hand, worldwide taxation has been widely implemented in the 1970s by the majority of Western countries (for example, with the implementation of Controlled Foreign Companies regimes), in more recent years, there has been a substantial reversal of scenario, with the tendency, on the part of countries, to reduce the scope of their fiscal jurisdiction and the consequent implementation of "hybrid" tax models with a large number of influences coming from territorial taxation (e.g., France, the United Kingdom, Denmark, Hong Kong and many Latin American countries)[614].

More in particular, some countries currently tax business income exclusively on a source basis. For instance, since the Montevideo conference in 1956, many Latin American countries consider that international law limits fiscal jurisdiction only to income sourced within the territory of the state[615]. This view has been embodied in the model tax treaty elaborated by the Andean group, even though several Latin American countries, such as Brazil and Argentina, have recently moved to a fiscal system entailing taxation of worldwide income for residents.

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[613] Amongst them, see, for example, Kemmeren, E.C.C.M., *Double tax conventions on income and capital and the EU: past, present and future*, cited above, 157; Vogel, K., *Worldwide vs. source taxation of income - A review and re-evaluation of arguments*, cited above, 8-10; Desai, M.A., Hines, J.R., *Evaluating international tax reform*, National Tax Journal, 2003, 56, 487.
[614] Ault, H., *Comparative income taxation: a structural analysis*, The Hague, 1997, 23.
[615] Monsenego, J., *Taxation of foreign business income within the European Internal Market*, cited above, 79.

According to Vogel, only Argentina, Uruguay and Hong Kong have, as of today, implemented a "purely" territorial tax system, while all other countries have either implemented a traditional "hybrid worldwide" tax system (worldwide taxation for residents and "territorial" taxation at source for non-residents) or have enhanced certain territorial characteristics of their tax system, thus adhering to a fiscal model based on a sort of "tempered territoriality" (this is the case, for example, of the French tax system, as we will see, where only corporations are *a priori* subject to an essentially territorial model of taxation)[616].

With regards to the taxation of income earned abroad by multinational companies, it has been highlighted that, over the past forty years, there has been a pronounced shift, at international level, on the part of capital-exporting countries, towards use of territorial tax systems, with the implementation of "participation exemption" regimes by way of which active business income earned abroad by foreign subsidiaries is (wholly or partially) exempt from taxation by the home country and no tax credit for foreign taxes is granted[617]. On the other hand, non-equity income, such as interest and royalties, remains generally taxable in countries with both "worldwide" and "territorial" tax systems, with a tax credit for foreign withholding taxes being generally allowed.

In the European Union context, many studies have observed a substantial degree of "homogenisation" of the tax systems of different Member States, especially as corporate income taxation is concerned, with a clearly identifiable "circulation" of tax models[618]. Examples of this tendency can be found, for instance, in the steps taken towards the abandonment of the traditional tax credit system and the adoption of the exemption method with regards to dividends and capital gains on participations in companies (participation exemption regimes)[619], in the adoption of Controlled Foreign

[616] Vogel, K., *General Report*, in International Fiscal Association, *Interpretation of double taxation conventions*, Rotterdam, 1993, 66.
[617] It has been documented that the number of current OECD member countries with territorial tax systems has doubled since 2000. Countries resorting to participation exemption regimes are, for instance, Italy, Belgium, France, Germany, the United Kingdom, the Netherlands, Portugal, Spain, Sweden and Greece (amongst which some countries exempt 100 per cent of the foreign subsidiaries' dividends, while some other countries exempt at least 95 per cent of such dividends), while countries such as the United States, Ireland and Mexico still encompass a "worldwide" tax systems with a tax credit being granted for foreign taxes. Many countries resorting to participation exemption regimes also exempt gains deriving from the sale of shares of the foreign subsidiary.
[618] Garbarino, C., *Tax transplants and circulation of corporate tax models*, in British Tax Review, 2011, 158.
[619] Barassi, M., *Circolazione dei modelli tributari e comparazione*, in Rivista di Diritto Tributario, 2013, 2, 513.

Companies regimes[620] and in the establishment of forms of group consolidation sometimes going beyond the borders of the Member States concerned[621].

In light of all of the above, and coming to the specific purpose of the research, we will now analyse and compare the main functioning of the tax systems of three different European countries and how they have chosen to identify the territorial connections which they deem necessary in order to exercise their taxing powers on transnational items of income. The choice of the countries that will constitute the focus of the following analysis has been made on the ground of the need to take into consideration radically different tax models in light of the traced distinction between worldwide tax systems and "territorial" tax systems.

Therefore, the first of the chosen countries has been Italy, which has a long-standing tradition of adhering to the worldwide tax model in its "conventional" form, with both individuals and legal entities being taxed on all of their income, wherever accrued, if they reside in Italy and non-residents (regardless of them being individuals or corporations) being taxed only on the portion of their income which is produced within Italian territory. Then, the analysis will move to the opposite model, with attention being paid to France, which has an equally long-standing tradition of territorial taxation, even though limited to corporate taxation: whereas French-resident individuals are taxed on their worldwide income as Italian-resident individuals are, France levies corporate taxes only on the income produced within French territory, either accrued or owned by resident corporations or by non-resident corporations. Finally, we will examine a "hybrid" system, that is to say the United Kingdom's tax system, which can generally be defined as adhering to the worldwide tax model, but which, nonetheless, in more recent times, has been gradually shifting towards more territorial inclinations.

In the analysis of all three of the mentioned tax models specific attention will be paid to the level of integration of those countries' fiscal systems in general and more specific tax measures with the provisions of European Union law and with the principles developed by the Court of Justice of the European Union. The last part of the present chapter will, therefore, focus on the recent evolutions of the three countries' fiscal measures on exit taxation and Controlled Foreign Companies, and especially on how such measures have evolved after the judgements rendered by the Court of Justice on the

[620] Stizza, P., *La disciplina fiscale delle Controlled Foreign Corporations in Italia, Francia e Regno Unito*, in Diritto e Pratica Tributaria Internazionale, 2010, 1403.

[621] Marino, G., *L'IRES nel contesto della tassazione delle società nella UE: bilanci e prospettive*, in Rassegna Tributaria, 2015, 1, 131.

point, and their compatibility with the recently adopted relevant measure of the Anti-Tax Avoidance Directive.

2. Italy: a "traditional" worldwide tax model.

The current Italian tax system is structured so as to resident taxpayers are taxed on their worldwide income (so-called "*utile mondiale*") regardless of that income having being produced in Italian territory or abroad and non-resident taxpayers are taxed only on the portion of their income produced within Italian territory. In the late 70s, Italy has, in fact, shifted from an income tax model of a mostly "real" nature to the implementation of an income tax which is essentially "personal" and based on the worldwide taxation model, as far as resident taxpayers are concerned, while a more territorial approach is implemented concerning non-residents[622].

As unanimously observed, therefore, the nature of the connection between the taxpayer and the Italian territory influences the extension of the tax charge: if a taxpayer is bound to Italy by way of a strong and stable connection - i.e. residence - he/she/it shall have a more "intense" duty to contribute to public expenditure, with the amount of taxes due being computed with regard to all of his/her/its income, wherever accrued; on the other hand, in case of a subject not so strongly bound to Italy, such as a non-resident (being him/her/it an Italian citizen or a "foreigner"), the intensity of the duty to contribute to the Italian public coffers is lessened ad tax will be imposed only on such items of income as they are objectively connected with the Italian territory[623].

According to the most authoritative doctrine, this particular structure of Italian tax law finds its roots in Constitutional provisions and, more specifically, in Article 53 of the Italian Constitution. Pursuant to paragraph 1 of Article 53, in fact, "*Anybody must contribute to public expenditure depending on their ability to pay*"[624]. It should be highlighted from the outset, before proceeding in the analysis of the repercussions of such a statement on the structure of the Italian tax system, that the English term "ability to pay", especially as developed by the Court of Justice of the European Union's jurisprudence, does not exactly coincide with the actual meaning of the Italian concept of "*capacità contributiva*": in fact, whereas the concept of "ability to pay", in the words of the

[622] For a brief overview of the evolution of the Italian income tax system from a "real" model to a "personal" model, see, amongst others, Melis, G., *La nozione di residenza fiscale delle persone fisiche nell'ordinamento tributario italiano*, cited above, 103. For a historic overview, see also Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 271-279.
[623] Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 270.
[624] The original text of Article 53, paragraph 1, of the Italian Constitution reads as follows: "*Tutti sono tenuti a concorrere alle spese pubbliche in ragione della loro capacità contributiva*".

Luxembourg Judges, is generally described and resorted to as a criterion for the allocation of taxing powers amongst Member States - which, to a certain extent, functions as the "theoretical counterpart" of allocating criteria based on the "principle of territoriality" - the Italian "*capacità contributiva*" concept refers to a more general principle based on the need to guarantee substantial equality and social justice between citizens, even in the levying of taxes, and according to which the State must levy taxes on its taxpayers on the grounds of their actual wealth, without any direct or indirect discrimination[625].

Italian legal scholarship has found that the term "*anybody*" ("*tutti*"), in Article 53 of the Constitution, is a sign of a necessary wide involvement in the contribution to public expenses[626], including foreigners and non-residents, since the wording of Article 53 does not limit the extension of the duty to contribute to the public coffers to citizens and/or residents only. It goes without saying that such a wide definition of the subjects that have to contribute to the Italian public expenditure needs to be limited and better defined, especially with regard to foreigners and non-residents, on the ground of a stable and significant link of an economic nature between these subjects and the territory of the Italian State[627].

Said link may either have an "objective" nature, as in the case of the enactment of an economic activity or the simple possession of an item of income in the territory of the State, or a "subjective" nature, thus linking the definition of who should contribute to the State's public expenditure on the ground of a certain status, such as citizenship or the habitual presence of a subject within the territory of the State[628].

The choice of the Italian tax legislature has been to identify that significant link on the basis of a distinction based on the paramount concept of residence, as the expression

[625] On one hand, a considerable number of Italian authors, together with the Italian Constitutional Court, interpret the principle enshrined in Article 53 of the Constitution as an expression of the general principle of equality provided for by Article 3 of the Constitution, ensuring that all those who are called to contribute to public expenditure do so on the basis of their actual possibility and economic capacity. Of this opinion, see, for example, Fedele, A., *Appunti dalle lezioni di diritto tributario*, Rome, 2003, 32; Fedele, A., *La funzione fiscale e la capacità contributiva nella Costituzione italiana*, in Perrone, L., Berliri, C. (eds.), *Diritto tributario e Corte Costituzionale*, Naples, 2006, 1; Gallo, F., *Le ragioni del fisco. Etica e giustizia nella tassazione*, Bologna, 2007, 97. Another part of the Italian doctrine has, however, argued for the need to separate the analysis of the concept of "*capacità contributiva*" from the principle of equality enshrined in Article 3 of the Constitution, i.e. as an autonomous concept based on the recognition of the fiscal interest of the State and forcing the legislature to always look for a connection between the tax imposed and the tax object, in a perspective based on the "internal coherence" of the fiscal measure. Of this opinion, see Falsitta, G., *Manuale di diritto tributario. Parte generale*, Padua, 2015, 151. Adhering to the first theory, which is nowadays the prevalent one, implies recognising the existence of limits of the possibility, for the State, to levy taxes. On the point, see Moschetti, F., *Il principio di capacità contributiva - espressione di un sistema di valori che informa il rapporto tra singolo e comunità*, Padua, 1993, 18.

[626] Antonini, L., *Dovere tributario, interesse fiscale e diritti costituzionali*, Milan, 1996, *passim*; Sacchetto, C., *Territorialità*, cited above, 304; Moschetti, F., *Il principio di capacità contributiva*, cited above, *passim*.

[627] Moschetti, F., *Il principio di capacità contributiva*, cited above, 215.

[628] Melis, G., *La nozione di residenza fiscale delle persone fisiche nell'ordinamento tributario italiano*, cited above, 1045; Fregni, M.C., *La residenza fiscale delle persone fisiche*, in Giurisprudenza Italiana, 2009, 2564.

of a particularly relevant and intense connection between a subject and the territory of the State, justifying a higher tax burden. The worldwide nature of the Italian tax model has always been accompanied by the adoption of the credit method for the elimination of international double taxation.

As far as individual income taxation is concerned, Article 3 of Presidential Decree 917/1986 ("*Testo Unico delle Imposte sul Reddito*", i.e. the Italian "Income Tax Code") established that all subjects that are resident in the territory of the State are taxed on their income wherever accrued, with a correspondent tax credit being granted to residents for taxes paid abroad pursuant to Article 165 of Presidential Decree 917/1986. On the other hand, as far as non-residents are concerned, tax is levied only exclusively on income produced within the territory of the Italian State.

The same applies with regards to corporate income taxation. Article 73, paragraph 1, letter d), of Presidential Decree 917/1986 lists, amongst the subjects that are considered as taxable for the purposes of Corporate Income Tax ("*Imposta sul Reddito delle Società*", also known as "*IRES*"), "*companies and entities, including trusts, with or without juridical personality*" that do not reside within the territory of the State and paragraph 2 of the same Article specifies that partnerships ("*società di persone*") and similar subjects fall within the scope of application of Italian Corporate Income Tax[629]. Furthermore, Articles 151 and 153 of Presidential Decree 917/1986 establish that commercial and non-commercial non-resident entities are taxed in Italy "*only on income produced in the territory of the State, with the exclusion of income that is exempted from taxation and of income that is subject to a final withholding tax or a substitute tax*".

As already highlighted in other parts of the present research, it might prove considerably difficult to identify the "source" of a certain item of income and, therefore, to understand when that item of income can be considered as produced in the territory of the State. Article 23 of Presidential Decree 917/1986 provides for specific connecting criteria with regard to income that is considered as produced in Italian territory[630]. We will not dwell on the content of such a provision, as the analysis of the single linking criteria would go beyond the scope of the present research. Suffice it here to say, without claiming to be complete, that the criteria envisaged by Article 23 are, in general terms,

[629] Whereas, with regard to resident taxpayers that are subject to Corporate Income Tax, Article 73 of Presidential Decree 917/1986 distinguishes between "commercial entities" and "non-commercial entities" and between partnerships and corporations. Furthermore, partnerships ("*società di persone*") and similar subjects, if they are considered as residing in Italian territory, are taxed according to a mechanism based on transparency, while, on the other hand, this is not the case if such subjects do not reside in Italy. On the point, see Perrone, L., *L'imposizione del reddito delle società e degli enti non residenti*, in Rassegna Tributaria, 1989, 3, 570.

[630] Rosenbloom, H.D., Garbarino, C., *Analisi comparata delle norme per la localizzazione dei redditi negli ordinamenti tributari italiano e statunitense*, in Diritto e Pratica Tributaria, 1988, 529.

based either on the location of the income-producing assets, on the place where the income-producing activity is put in place or on the place of residence of the subject paying the amount constituting the income.

For the sake of completeness, it should also be recalled that non-residents subjects having a permanent establishment in Italy are taxed, pursuant to Article 152 of Presidential Decree 917/1986, on the income attributable to that permanent establishment. In this case, the income attributable to the permanent establishment is subtracted from the implementation of the "isolated treatment" that is applied to single items of non-residents income produced in Italy, being unitarily considered through the general criteria applicable to business income produced by resident subjects[631]. We will not dwell, here, and also for all other tax systems that will be analysed in the following pages, on the implications of the notion of "permanent establishment" on corporate taxation, since the issues concerning permanent establishments (how to define it, which consequences should be attributed to their presence within a certain territory…) would deserve an in-depth analysis which cannot be conducted here and which is ultimately not essential to the purpose of the present research.

2.1. The Italian concept of "fiscal residence" and its possible extraterritorial extensions.

Italy bases its definition of the residence status on a "hybrid" system, where one of the relevant criteria is of a formal nature (based on the civil registry of the resident population), whereas two of them (domicile and residence pursuant to Article 43 of the Civil Code) are more focused on substantial approach, aimed at verifying the actual reality of the condition of the subject concerned. However, contrarily, for example, to UK tax law[632], Italian tax law does not encompass any definition of a "non-resident", which should, therefore, be derived *a contrario* from the definition of "resident" provided for by Article 2.

More in detail, Article 2, paragraph 2, of Presidential Decree n. 917/1986 provides that an individual is considered as residing in Italy for tax purposes if he/she is either listed in the civil registry of the resident population, or has his/her domicile in the

[631] In light of the characteristics of the regime, many authors have defined the permanent establishment as, according to Italian tax law, a "quasi-subject", halfway between a mere connecting criterion and a proper tax subject. On the point, see Gallo, F., *Contributo all'elaborazione del concetto di 'stabile organizzazione' secondo il diritto interno*, in Rivista di Diritto Finanziario e Scienza delle Finanze, 1985, 1, 385.
[632] Reference is made to the so-called "statutory residence test", which will be further analysed in the present Chapte.

territory of the State (interpreted as the main location of moral, material and business relation pursuant to Article 43 of the Civil Code), or has his/her habitual abode in Italy pursuant to Article 43 of the Civil Code. No attention is paid, for these purposes, to the element of the continual permanence within the territory of the State, with prevalence being given to "qualitative", rather than "quantitative", criteria[633].

The jurisprudence of the Italian Supreme Court has substantially found that the particular relevance of the civil registry of the population for tax purposes, as described by Article 2 of Presidential Decree 917/1986, constitutes a clear example of form prevailing over substance, with the criterion based on being listed in that registry constituting an absolute presumption for tax purposes[634], whose existence precludes any other possible check aimed at ascertaining fiscal residence and any possibility for the taxpayer to present evidence to the contrary[635].

It should, however, be recalled that large part of the Italian legal scholarship has strongly criticised the use of a purely formal requirement such as being listed in the civil registry of the resident population in order to define an individual as fiscally resident in Italy, with the consequent levying of taxes on all of its worldwide income, wherever originated[636]. Many have, in fact, interpreted this criterion as not actually able to be grounded on a real attachment between the taxpayer and the Italian territory, which would justify the exercise of taxing powers, on the part of the Italian State, even in the absence of an effective connection with the taxpayer, i.e. a sort of "extraterritorial" exercise of taxing powers. Many have even argued for a hypothetical constitutional incompatibility of such a provision with Article 53 of the Italian Constitution, in its interpretation according to which, as seen above, there needs to be a certain, effective and stable (and not merely formal) link between the taxpayer and the territory of the

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[633] Fantozzi, A., Paparella, F., *Lezioni di diritto tributario dell'impresa*, Padua, 2014, 42; Marongiu, G., *Domicilio, residenza, dimora nel diritto tributario*, in Dig. disc. priv. sez. comm., Turin, 1990, vol. V, 142.

[634] Whereas, according to general Italian civil law, such data can constitute the ground only for relative presumptions. On the point, see Piantavigna, P., *La funzione della nozione di 'residenza fiscale' nell'IRPEF*, in Rivista di Diritto Finanziario, 2013, 3, 275.

[635] Supreme Court of Cassation (*Corte di Cassazione*), 20 April 2006, 9319; Supreme Court of Cassation, 3 March 1999, 1783; Supreme Court of Cassation, 6 February 1998, 1215.

[636] Melis, G., *La nozione di residenza fiscale delle persone fisiche nell'ordinamento tributario italiano*, cited above, 1045; Melis, G., *Riflessioni intorno alla presunzione di residenza fiscale di cui all'art. 10 della l. 23 dicembre 1998, n. 448*, in Rassegna Tributaria, 1999, 4, 1082; Maisto, G., *Iscrizione anagrafica e residenza fiscale ai fini dell'imposta sul reddito delle persone fisiche*, in Rivista di Diritto Tributario, 1998, 4, 222; Maisto, G., *La residenza fiscale delle persone fisiche emigrate in Stati o territori aventi regime tributario privilegiato*, in Rivista di Diritto Tributario, 1999, 4, 57; Marino, G., *La residenza nel diritto tributario*, cited above, 30; Lupi, R., *Territorialità del tributo*, cited above, 4. *Contra*, see Fransoni, G., *La territorialità nel diritto tributario*, cited above, 360: the Author, in fact, distinguishes between the case where the insertion in the civil registry of the resident population has been asked and obtained by the taxpayer and, on the other hand, the case where the inserion in such registry has not been asked by the taxpayer and does not reflect the actual reality of the circumstances. In the first case, according to the Author, the criterion based on the analysis of the civil registry of the resident population can be considered as suitable to the purpose of identifying a resident individual because the circumstance would reflect the actual will of the taxpayer, who has voluntarily declared his/her attachment to the Italian State. The last-mentioned thesis is not supported by Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 229.

State levying taxes: legal doctrine has, therefore, highlighted that an element such as being listed in the civil registry of the population, which has been created essentially for "statistical" purposes, would not actually reflect any actual connection with Italy on the part of a certain subject.

These arguments may also be upheld by the analysis of the international tax practice, constituted by the network of tax treaties concluded by the states and by the OECD Model Convention, where the notion of "residence" (enshrined, for instance, in Article 4 of the above-mentioned OECD Model Convention) is based on the adoption of "substantial" connecting criteria, aiming at reflecting, at least on a theoretical level, an actual and effective tie between the taxpayer and the territory[637].

Some authors have found another reason to sustain the criticism to the criterion based on the public registry of the population in the hypothetical rules deriving from international tax law, arguing, more specifically, that the rule at issue would be contrary to the principle enshrined in general international law, pursuant to which a foreigner cannot be taxed by any state if not by virtue of a sufficient or reasonable connection between that foreigner and the state levying taxes. According to this position, Article 2 of Presidential Decree 917/1986 would even be contrary to the Italian Constitution and, more in detail, with Article 10 of the Constitution, which prescribes the need for Italy to conform to general international law[638]. However, this theory does not appear as entirely convincing, given all that has been highlighted in the previous chapters of the present research, as to the absence, in international law, of any effective and binding principle as the one mentioned above and, in particular, the fact that countries seem to adhere to the "reasonable connection theory" not because they consider they are bound to do so by international law, but because of more practical and "political" reasons[639-640].

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[637] Piantavigna, P., *La funzione della nozione di 'residenza fiscale' nell'IRPEF*, cited above, 280; Marello, E., *La residenza fiscale nelle convenzioni internazionali*, in Giurisprudenza Italiana, 2009, 2591; Baggio, R., *La perdita e l'acquisto della residenza fiscale: quadro d'insieme ed aspetti controversi*, in Rivista di Diritto Tributario, 2006, 1, 537.

[638] Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 282.

[639] On the point, see Chapter 1 of the present research.

[640] Some authors have also highlighted that another important suggestion has come from European Union law and, in particular, from the jurisprudence of the Court of Justice of the European Union, which has elaborated a notion of "normal residence" based on the (now repealed) provision of Article 7 of Directive 82/182/EEC on tax exemptions within the European Union for certain means of transport temporarily imported into one Member State from another Member State. More specifically, the Luxembourg Judges, with regards to cases not concerning direct taxation, have stated that, in order to identify the place of a person's normal residence, an evaluation concerning all relevant factual elements should be put in place, with attention having to be paid to the place where the permanent centre of such person's interest lies, giving prevalence to "business ties" over "personal ties", which should be looked at only if the analysis of the "business ties" proves not to be conclusive. On the interpretation of the concept of "normal residence", see Court of Justice of the European Union, 12 July 2001, C-262/99, *Louloudakis*; Court of Justice of the European Union, 23 April 1991, C-297/89, *Ryborg*; Court of Justice of the European Union, 26 April 2007, C-392/05, *Alevizos*. On the point, see also Piantavigna, P., *La funzione della nozione di 'residenza fiscale' nell'IRPEF*, cited above, 288; Tassani, T., *Transfer of residence and exit taxation in EU law: the Italian approach*, in European Tax Studies, 2009, 1.

For all of these reasons, some Italian authors have concluded that, in order to ensure the compatibility of Article 2 of Presidential Decree 917/1986 with the Italian Constitution, the element of proof based on a subject being listed in the civil registry of the population should not be deemed as a sufficient condition in order for him/her to be considered as fiscally resident in Italy (and thus being subject to taxation on all of his/her income, wherever accrued), but should be turned into a relative presumption of fiscal residence, open to the possibility for the taxpayer to demonstrate otherwise in order to escape worldwide taxation[641].

This hypothesis would, on one hand, eliminate a difference between Italy and other European countries, which focus more on substantial elements for the purposes of defining fiscal residence and would also probably, on the other hand, be in line with European Union law and, in particular, with the "*Cadbury Schweppes*" doctrine on prevalence of substance over form.

Going back to the main topic, it should also be highlighted that Article 2, paragraph 2-*bis*, of Presidential Decree 917/1986 also provides for a presumption of residence in the territory of the State for all citizens who remove themselves from the civil registry of the resident population so as to migrate to certain other countries[642], listed in a specific Ministerial Decree, i.e. to countries with more favourable fiscal regimes. In this case, such migrating citizens are tasked with the *onus probandi* to demonstrate, through any mean possible, that their transfer abroad has not been put in place only in light of tax purposes and, therefore, that they do not maintain the centre of their main interests in Italy and that they have severed all significant relations with the Italian State. This measure has been defined as a sort of "exit taxation provision" concerning individual taxpayers[643].

2.2. Corporate fiscal residence and deemed residence in Italian tax law: the measures countering "*esterovestizione*" and the extraterritorial extension of the State's taxing powers.

Italian tax law grounds the fiscal residence of companies and other entities different from individuals, which entails worldwide taxation on such entities on all of

[641] Melis, G., *La nozione di residenza fiscale delle persone fisiche nell'ordinamento tributario italiano*, cited above, 1045; Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 282.

[642] Italian citizens, when migrating abroad, have to be listed in the registry of the Italian population residing abroad ("*AIRE*"), which constitutes a distinct registry system which is not, *per se*, enough to demonstrate the absence of a domicile or of residence in the Italian territory.

[643] Fantozzi, A., Paparella, F., *Lezioni di diritto tributario dell'impresa*, cited above, 43.

their income, wherever produced, on three criteria, that is to say the entity's legal seat, its administrative seat or its main object, with the burden of proof concerning the existence of these conditions lying on the tax administration. As for individuals, the structure of the rule, therefore, requires the presence of two conditions: a "temporal" one, i.e. the entity needs to reside in Italy *"for the most part of the tax period"*, and a "factual" and "substantial" one, which is described by Italian tax law by reference to three alternative conditions (legal seat, administrative seat or main object of the activity).

More in detail, Article 73 of Presidential Decree 917/1986 establishes that *"for income tax purposes, companies and legal entities are considered residents if, for the most part of the tax period, they have their legal seat or their administrative seat or the main object within the territory of the State"*. This wide-ranging definition of corporate residence actually mirrors the characteristics of the Italian worldwide income tax model, with resident corporations being subject to income taxation in Italy on their income, wherever accrued, with an extension of the relevant connecting factors with the domestic legal order.

The criterion based on the location of the company's legal seat is of an essentially formal nature. However, scholars are essentially unanimous in stating that such a criterion cannot encounter the same criticism concerning the application, to individuals, of the formal parameter based on being listed in the civil registry of the resident population in order for an individual to be subject to Personal Income Tax[644]. As far as corporations are concerned, in fact, the legal seat has a considerably more significant role than the simple inclusion in the civil registry for individuals, being it generally enshrined in the corporate statutes, as the result of a specific willing choice on the part of the company concerned and as the primary indication as to which law should be interpreted as the law governing the corporation, with all consequent rights and obligations connected to the applicable law. Referring to the legal seat of a company, therefore, means referring to a concept which is significantly less "formal" than the one applicable to individuals.

On the other hand, the concept of "*administrative seat*" broadly coincides with the concept of "place of effective management" mentioned by Article 4 of the OECD Model Convention and aims at identifying, on a factual basis, the place where the company's administrative body exercises the strategic management power relevant for the purposes of governing the company and adopts the most relevant decisions for the organisation

[644] Authors have highlighted that the rule based on the entity's legal seat in order to determine its fiscal residence is of a "formal, but not formalistic" nature. Of this opinion, for example, Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 300.

and management of the entity[645]. Part of the legal scholarship argues that, in identifying the company's administrative seat, reference should be made to the place where the ordinary day-to-day management takes place[646], whereas larger part of the doctrine considers as relevant to these purposes the place where the main and top-tier managing guidelines are adopted.[647]

The third "factual" condition for locating the company's residence within Italian territory is constituted by the localisation of the company's "*main object*". On this point, Article 73 specifies that "*the exclusive or principal object […] is determined on the ground of the law, the memorandum and articles of association or the company's statutes, if existing in the form of authentic instrument*" and that "*the main object is the essential activity for the direct realisation of the primary purposes established by law, by the memorandum and articles of association or by the statutes*". With regard to this last concept, it has been highlighted by part of the Italian legal scholarship that the criterion would not be sufficiently clear, since it would not be possible to identify the place where "a purpose is located".

Ultimately, the above-mentioned provision clarifies that, in case the memorandum and articles of association or the statutes are lacking, the resident entity's main object is determined on the basis of the activity effectively exercised in the territory of the State and that this criterion is the only one applicable to non-resident entities: in other words, the analysis on the "main object" of a foreign corporation cannot be conducted with regards to that corporation's statutes, but only with regard to the activity actually conducted in the territory of the State.

Authors have generally highlighted that, as opposed to the mechanisms regulating the concept of "residence" in other fields of law (e.g. conflict of laws), the above-mentioned provisions result, in the administrative practice, in a general predominance of the "effective seat" criterion over the criterion based on the "formal seat", which is considered relevant by Italian tax law only insofar as every other connecting criteria would locate the company outside the scope of application of the Italian legal order[648]. Prevalence is, therefore, generally granted to the "substantial"

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[645] Fantozzi, A., Paparella, F., *Lezioni di diritto tributario dell'impresa*, cited above, 288; Marino, G., *La residenza nel diritto tributario*, Padua, 1999, 104; Zizzo, G., *Reddito delle persone giuridiche*, in Rivista di Diritto Tributario, 1994, 1, 650; Garbarino, C., *La tassazione del reddito transnazionale*, cited above, 186; Manzitti, A., *Considerazioni in tema di residenza fiscale delle società*, in Rivista di Diritto Tributario, 1998, 1, 181; Iascone, E., *La residenza fiscale delle società: il caso delle holding di partecipazioni*, in Rivista di Diritto Tributario, 2008, 1, 178.

[646] Covino, E., *Sede dell'amministrazione, oggetto principale e residenza fiscale delle società*, in Dialoghi di Diritto Tributario, 2005, 2, 927.

[647] Marino, G., *La residenza nel diritto tributario*, cited above, 118; Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 302.

[648] Dorigo, S., *Residenza fiscale delle società e libertà di stabilimento nell'Unione Europea*, cited above, 55; Melis, G., *La residenza fiscale dei soggetti IRES e l'inversione dell'onere probatorio di cui all'art. 73, commi 5-bis e 5-ter T.U.I.R.",* in Diritto e pratica internazionale, 2007, 3, 781; De Broe, L., *Corporate tax residence in civil law jurisdictions*, in Maisto,

connecting criteria, with Italian fiscal residence being attributed to entities that, in their day-to-day activities, are linked to the Italian legal order, irrespective of where they have been incorporated or of where their "official" legal seat is located. With all consequent issues concerning the difficulty of providing a uniform definition of "effective legal seat" and of finding criteria to define the cases in which the administration of a company is actually conducted within Italian territory.

For decades, rules concerning fiscal residence have not attracted the attention of the Italian lawmaker. Starting from 2006, however, several modifications have been put in place with regard to the general criteria concerning corporate residence, with the introduction of presumptive mechanisms aimed at countering phenomena leading to base erosion and profit shifting by way of the fictitious and elusive delocalisation of income in foreign territory through the establishment of companies which are effectively deprived of any actual and real connection with their territory of establishment[649].

Pursuant to the criteria described by Article 73, Italian tax law, as many other national legal orders, encompasses provisions revolving around an inversion of the burden of proof between taxpayers and tax authorities, with a presumption of fiscal residence within the territory of the State where certain pre-determined circumstances occur.

Therefore, paragraph 5-*bis* of above-mentioned Article 73 of Presidential Decree 917/1986 provides that it is presumed that the administrative seat of foreign companies or entities directly controlling Italian companies or entities is located in Italian territory for tax purposes; the same also applies to entities that are (also indirectly) controlled by subjects residing in the territory of the State or that are managed by a board of directors which is mainly made up of subjects residing in Italian territory[650]. Furthermore, paragraph 5-*quater* of Article 73 establishes that, unless proven otherwise, companies or entities are considered as residing in Italian territory for tax purposes if their capital is

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G. (ed.), *Residence of companies under tax treaties and EC law*, Amsterdam, 2009, 95. For a comparison with other normative experiences, see Avery Jones, J., *Corporate residence in common law: the origins and current issues*, Maisto, G. (ed.), *Residence of companies under tax treaties and EC law*, Amsterdam, 2009, 121; Sasseville, J., *The meaning of 'place of effective management*, in Maisto, G. (ed.), *Residence of companies under tax treaties and EC law*, Amsterdam, 2009, 287.

[649] Tassani, T., *Autonomia statutaria delle società di capitali e imposizione sui redditi*, Milan, 2007, 221; Marino, G., Lupi, R., *Quale valore sistematico per le nuove disposizioni sulla residenza in Italia delle holding estere?*, in Dialoghi di Diritto Tributario, 2006, 1013; Ballancin, A., *Note in tema di esterovestizione societaria tra i criteri costitutivi della nozione di residenza fiscale e l'interposizione elusiva di persona*, cited above, 975.

[650] More specifically, paragraph 5-*bis* of Presidential Decree 917/1986 provides that "*unless proven otherwise, the seat of the administration of companies and entities holding controlling shares pursuant to article 2359, paragraph 1, of the civil code in the subject mentioned by letters a) and b) of the first paragraph are considered as existing in the territory of the State if, alternatively, a) they are controlled, even indirectly, pursuant to article 2359, par. 1, of the civil code, by subjects residing in the territory of the State; b) are managed by a board of directors or other equivalent managing body mainly constituted of members residing in the territory of the State*". Similar provisions have been introduced in other states' tax laws as well, as we will see: on the point, see Melis, G., *Trasferimento della residenza all'estero ed elusione fiscale*, in Maisto, G. (ed.), *Elusione ed abuso del diritto tributario*, Milan, 2009, 231.

mainly invested in shares or participations of collective property investment entities and if are directly or indirectly controlled by Italian residents.

The consequence of this attribution of residence to "formally foreign" subjects can be easily understood: such subjects will be taxed on their worldwide income, wherever accrued. An exception being made for all cases where the foreign entity provides proof as to the effectiveness of its foreign residence.

With regard to the scope of application of the rules at issue, Italian doctrine and case law have generally referred to the concept of "*esterovestizione*", which roughly translates to a company's or an item of income's "relocation abroad" and refers to the setting up of companies (generally shell corporations) in countries with more favourable tax regimes (compared to the Italian tax regime), with the purpose of imputing to those companies item of income which would otherwise be accrued to Italian residents and would, therefore, be subject to tax in Italy. "*Esterovestizione*" is, therefore, generally considered as the operation by way of which a company formally allocates its fiscal residence in another country, even though it conducts its main activity in Italian territory or even though its administrative seat is located in Italy: the non-resident nature of the entity would, thus, be merely apparent, whereas the centre of its management, of its business and of its investments would be substantially located in Italy[651].

In light of this phenomenon, Italian tax law has established rules allowing to disregard, for tax purposes, the apparent collocation of companies in different countries, thus treating them like Italian resident and consequently taxing them on their worldwide income, like all other Italian residents, with the application of a substance-over-form provision in order to counter avoidance practices. The rationale behind the measure is the suspicions connected to the fact that the foreign company is linked to subjects residing in Italy both from the "active" side and from the "passive side".

Legal doctrine has, therefore, stated that, if viewed from this perspective, the very concept of "residence" and the traditional connecting criteria employed by states are used as anti-avoidance and anti-evasion tools[652-653], notwithstanding the fact that part of the Italian legal scholarship has argued - in a not entirely convincing way - that the above-

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[651] Greggi, M., *Recenti sviluppi e questioni di compatibilità comunitaria delle disposizioni di contrasto al fenomeno della cosiddetta esterovestizione societaria*, in Rassegna Tributaria, 2009, 1, 105.

[652] Cordeiro Guerra, R., *Il legislatore nazionale e l'elusione fiscale internazionale*, in Maisto, G. (ed.), *Elusione ed abuso del diritto tributario*, Milan, 2009, 211.

[653] According to part of the legal doctrine, however, the measures at issue are not entirely useful to the purpose for which they have been introduced. This is mainly due, according to this position, to the fact that the rules on countering phenomena of "*esterovestizione*" do not concern foreign companies, either controlled or managed by resident subjects, which produce in Italian territory other types of income, such as interest and royalties, through the fictitious transfer of the underlying properties to the foreign companies. On the point, see Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 326; Marino, G., Lupi, R., *Quale valore sistematico per le nuove disposizioni sulla residenza delle holding estere?*, cited above, 1013.

mentioned rules are supposed to have a merely procedural function, simplifying, to a certain extent, the tax authorities' task and placing on the taxpayer the burden to demonstrate the insufficiency of the company's attachment with the Italian legal order, but would have no substantial modifying influence on the functioning of the relevant connecting criteria for the purposes of the attribution of fiscal residence[654].

Which does not seem to be entirely true. Especially if we consider that the rules at issue, on the grounds of the elements described above (the control thresholds), effectively lead to the consequence of establishing a legal presumption of localisation of the seat of a company's administration and, therefore, of the fiscal residence of foreign companies, thus modifying to a considerable extent the relevance of the traditional connecting criteria which are necessary to consider an entity as an Italian resident. In other words, the Italian lawmaker has considered the above-mentioned circumstances as able to actually be the expression of a connection between a foreign subject and the Italian State (and territory), thus integrating the rules concerning residence. Not with new criteria, but on a different application of traditional criteria (such as the "administrative seat"), which essentially focus on the localisation of entities that are different from the one that constitutes the object of the analysis. Criteria that, according to some, are not able to be the expression of a true connection between the foreign subject and the territory of the State.

As it has been correctly highlighted, in fact, in order to counter phenomena such as those described above, the Italian lawmaker had two possible means: it could either modify the territorial criteria concerning the specific items of income produced abroad (especially passive income) or modify the territorial criteria concerning the residence of the subject receiving such items of income, thus extending the State's taxing powers not over the single item of income, but rather on the subject receiving it (and all of its income, wherever accrued and regardless of it being active or passive)[655]. Notwithstanding the fact that the Italian lawmaker opted for the second solution, which is characterised by a more "systematic" approach to the problem, both solutions would have in any way entailed a modification of the traditional territorial connecting criteria, either in an objective or subjective manner.

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[654] Dorigo, S., *Residenza fiscale delle società e libertà di stabilimento nell'Unione Europea*, cited above, 58.

[655] Greggi, M., *Recenti sviluppi e questioni di compatibilità comunitaria delle disposizioni di contrasto al fenomeno della cosiddetta esterovestizione societaria*, cited above, 110; Sacchetto, C., *L'evoluzione del principio di territorialità e la crisi della tassazione del reddito mondiale nel paese di residenza*, in Rivista di Diritto Tributario Internazionale, 2001, 1, 35; Perrone, L., *Problemi vecchi e nuovi in materia di imposizione sul reddito delle società e degli enti non residenti*, in Rassegna Tributaria, 2001, 5, 1227.

Provisions such as those described above show specific problems of compatibility with European Union law and, in particular, with the Treaty freedom of establishment, since they have the effect of essentially disregarding the choices made by entrepreneurs with regards to the place where they choose to conduct business, continuing to consider a company as (fiscally) resident in a certain country even after that entity has exercises its right to move across the territory of the Internal Market.

Doubts concerning the measures at issue and its compliance with European Union law have been voiced by influential Italian authors, wondering about the compatibility with EU law of a regime which, on the ground of objective elements such as the element of control (either active or passive), draws quite radical conclusions, such as the assignment of Italian residence and the consequent application of an unlimited liability to tax on worldwide income on subjects which are (more or less formally) not Italian residents. On paper, the measure constitutes an example of extraterritorial exercise of taxing powers on the part of the Italian State, which also leads to wonder whether or not there is an effective and substantial attachment connecting the foreign subject to the State levying taxes. Doubts have also been raised concerning the proportionality of the measure and its effective suitability to apply only to purely artificial arrangements aimed exclusively at tax avoidance.

The Court of Justice has only dealt with similar issues in non-tax judgements such as *Factortame*[656] and *Eurofood*[657], where the Judges have considered that the criteria which were similar to those around which the Italian measure at hand were not able to reflect any real link between the company that is controlled and managed from another Member State and that Member State[658], which has led some authors to extend the above-mentioned rulings to tax cases as well, arguing that the Italian provisions countering "*esterovestizione*" could not be considered as compatible with European Union law since they revolve on a merely "fictitious" and "unreal" link between the State and the taxpayer concerned. Some have even highlighted that the attitude that part of the Italian judges have assumed towards the problem of "*esterovestizione*" and the application of the rules at issue has been, so far, too extreme, with some decisions of local tax courts which, even though concerning companies duly constituted pursuant to the laws of another

[656] Court of Justice of the European Union, 19 June 1990, C-213/89, *The Queen v. Secretary of State for Transport, ex parte Factortame Ltd and others*.
[657] Court of Justice of the European Union, 2 May 2006, C-341/04, *Eurofood IFSC Ltd*.
[658] Dorigo, S., *Residenza fiscale delle società e libertà di stabilimento nell'Unione Europea*, cited above, 299; Pistone, P., *EC law and tax residence of companies*, in Maisto, G. (ed.), *Residence of companies under tax treaties and EC law*, Amsterdam, 2009, 183. Of the same opinion, Melis, G., *Trasferimento della residenza all'estero ed elusione fiscale*, cited above, 257; Tenore, M., *Italy*, in Maisto, G. (ed.), *Residence of companies under tax treaties and EC law*, Amsterdam, 2009, 519; Antonini, L., *Note critiche sulla presunzione in tema di residenza fiscale di società ed enti introdotta dal D.l. 4 luglio 2006, n. 223*, in Rivista di Diritto Tributario, 2008, 4, 181.

Member State, have found them to be mere instruments for the relocation abroad of income on the ground of the characteristics of the decision-making processes, revolving around Italian directors[659].

However, coming to the specific fiscal measure at hand, it is probably sound to state that the "*Cadbury Schweppes* doctrine" should apply to the evaluation of the existence of a possible infringement of EU law concerning Article 73 of Presidential Decree 917/1986, together with all the more recent case law on the point of the compatibility between European Union law and anti-avoidance measures[660]. According to said jurisprudence, a country's fiscal measure against tax avoidance, even though objectively discriminatory or restrictive of a fundamental Treaty freedom, may be justified in the light of relevant general interests, such as the need to guarantee a balanced allocation of taxing powers amongst Member States and the need to prevent abuse, and can be considered as proportionate if aimed at countering only the so-called "*wholly artificial arrangements*", i.e. structures deprived of any substantial effectiveness and established only for the purpose of obtaining undue tax advantages[661]. Moreover, the rule does not revolve around an absolute presumption, but entails the possibility for the taxpayer to provide proof as to the authenticity of the corporate structure concerned.

It cannot be doubted that, with regards to the measures at issue, there could be, in fact, hypothetical problems of compatibility with the Treaty fundamental freedoms in cases where the rule at issue applies to other Member States of the European Union, given that the provision, constituting an example of an "extraterritorial" exercise of taxing powers on the part of the Italian State, might have a dissuasive effect on persons residing in Italy planning to move to another EU Member State, exercising their freedom of movement and/or their freedom of establishment[662]. However, the mechanism of the rule at issue and its purpose might actually justify the measure in light of the jurisprudence of the Court of Justice, as examined in the second chapter of the research, since it is aimed at countering tax avoidance and purely artificial constructions. Furthermore, the presumption on which the rule is built is not absolute, but relative, and the rule does not pose any limit to the kind of evidence that the taxpayers concerned

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[659] Marino, G., Marzano, M., *La residenza delle società e controllo tra schemi OCSE ed episodi giurisprudenziali interni*, in Dialoghi di diritto tributario, 2008, 91; Dorigo, S., *Residenza fiscale delle società e libertà di stabilimento nell'Unione Europea*, cited above, 322.

[660] On the recent evolution of the Court of Justice's jurisprudence on measures countering tax avoidance and its interaction with the need to ensure a balanced allocation of taxing powers within the Internal Market and the consequent implications on territoriality, with judgements such as *Argenta*, see Chapter 2 of the present research, at paragraph 8.

[661] Whitehead, S., *Practical implications arising from the European Court's recent decisions concerning CFC legislation and dividend taxation*, in EC Tax Review, 2007, 2, 176.

[662] Greggi, M., *Recenti sviluppi e questioni di compatibilità comunitaria delle disposizioni di contrasto al fenomeno della cosiddetta esterovestizione societaria*, cited above, 111.

might present the tax authority in order to escape from the scope of application of the provision[663].

Some Italian authors, nonetheless, still express doubts concerning the compatibility of the measure at issue with European Union law, arguing that the Italian provisions against phenomena of "*esterovestizione*" would not be sufficiently selective and would enjoy a scope of application that is too wide, possibly including circumstances which do not pose any specific problem connected to the risk of undue tax savings as a consequence of the localisation of the company in foreign territory, especially since the protection of the State's fiscal interest may justify a restriction of the freedom of establishment only in case of artificial practices or arrangements: this would constitute a problem for the Italian measures at issue because, according to this position, they would apply not only to purely artificial structures, but alto to subjects putting in place commercial enterprises and trades abroad[664].

3. France: (pure?) territoriality "*à la française*".

France's tax system has been traditionally defined as "purely territorial", at least *prima facie*, with specific regards to juridical persons, which can be taxed only on their business income whose source can be located within French territory (or, better said, as we will see, only on income realised in the context of enterprises operating in France), while foreign-source income of French-resident companies generally is not subject to French tax. Over time, however, France has modified the structure of its tax regime with the introduction of some provisions that further enhanced the "territorial" characteristics of the French fiscal model.

This general criterion reflects a more global vision of state taxing powers, developed by French legal scholarship over the years. If, in fact, on one hand, Anglo-Saxon authors assimilate fiscal territoriality to the need to trace a connection between the territory of the State and the tax object, French authors generally treat territoriality as a widely applicable general concept, that is to say as a set of rules concerning the geographical area for the possibility of the state to levy taxes and by virtue of which it is necessary that, in the absence of any applicable double taxation convention, all connecting criteria allowing the state to exercise its taxing powers on a certain subject are of a territorial/objective nature, rather than of a subjective one.

[663] Of this opinion, Tassani, T., *Transfer of residence and exit taxation in EU law: the Italian approach*, cited above.
[664] Baggio, R., *Il principio di territorialità ed i limiti alla potestà tributaria*, cited above, 329.

The concepts of "territory" and "territoriality" have, nonetheless, always played a more than central role in French legal scholarship with regards to the question of the extension, and the very justification, of the State's taxing powers, with French doctrine having traditionally developed a "territorial" vision of the state fiscal competence. The majority of French scholars agree on the fact that the state's tax jurisdiction is exclusively territorial, being it necessary to find a connection of a territorial nature between the tax object/subject and the state levying the tax[665]. Starting from these assumptions, French tax law has traditionally adopted a principle of territoriality of taxation for corporations, by virtue of which companies, regardless of them being either resident or non-resident for fiscal purposes, are taxed only on their income having their source within French territory, and, more precisely, on their income realised by and within enterprises exploited in France[666].

It should be highlighted at the outset that, although technically the ability-to-pay principle is not expressly mentioned in the 1958 French Constitution, a general (and constitutional) principle similar to the Italian "*capacità contributiva*" is nonetheless enshrined in Article 13 of the 1789 *Déclaration des droits de l'homme et du citoyen*, which states: "*Pour l'entretien de la force publique, et pour les dépenses d'administration, une contribution commune est indispensable; elle doit être également repartie entre tous les citoyens, en raison de leurs facultés*"[667]. French authors consider this principle as a corollary of a more general equality principle and highlight its essential role in a fair and equitable allocation of tax burden amongst taxpayers (residents and non-residents)[668].

As far as individuals are concerned, the French tax system appears considerably similar to the Italian one, as described above, and to the essential traits of the UK tax model (exception being made for the distinction between "residence" and "domicile" and the specific provisions on taxation on a remittance basis), that we will see in the following pages of the present research, which is one of the reasons why we will not dwell on the details of the extension of French taxing powers with concern to individual taxpayers. Suffice to say here that, according to French tax law, individuals residing in France for fiscal purposes are taxed on their worldwide income, wherever accrued,

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[665] Melot, N., *Territorialité et mondialité de l'impôt: étude de l'imposition des bénéfices des sociétés de capitaux à la lumiere des expériences française et américaine*, Paris, 2004, 1; Cartou, L., *Droit fiscal international et européen*, Paris, 1986, 14; Mann, F., *The doctrine of international jurisdiction revised after twenty years*, in Collected Course of the Hague Academy of International Law, Boston, 1984, 20; Gest, G., Tixier, G., *Droit fiscal international*, Paris, 1990, 14; Cozian, M., *Les grands principes de la fiscalité des entreprises*, Paris, 1999.

[666] Douvier, P.J., *Droit fiscal dans les relations internationales*, Paris, 1996, 125; Castagnède, B., *Précis de fiscalité internaitonale*, Lyon, 2002, *passim*.

[667] The 1958 French Constitution's preamble expressly references the 1789 Declaration of rights.

[668] Bouvier, M., *Introduction au droit fiscal générale et à la théorie de l'impôt*, Dalloz, 2008, 53.

whereas non-resident individuals are charged to tax only on the income produced within French territory[669].

Attention should, on the other hand, be paid to the field of corporate taxation.

Article 205 of the French *Code Général des Impots* (CGI) provides that "*il est établi un impôt sur l'ensemble des benefices ou revenus réalisés par les sociétés et autres personnes morales désignées à l'article 206*". Pursuant to Article 206 CGI, a list is established of legal entities subjected to corporation tax: that list is mainly drafted on the ground of French commercial law, but it is open to all other juridical persons which conduct business or otherwise lucrative activities, which means that the taxing powers of the French State extend to foreign corporations as well, by way of a qualification based on the analogy between said foreign entities and the companies envisaged in the list enshrined in Article 206, provided that it conducts a lucrative/business activity within French territory[670].

The scope of French taxing powers with regards to corporations is, then, further specified and limited by Article 209-I CGI, pursuant to which "*les bénéfices passible de l'impôt sur les sociétés sont déterminés […] en tenant compte uniquement des bénéfices réalisés dans les entreprises exploitées en France ainsi que de ceux dont l'imposition est attibuée à la France par une convention internationale relative aux double impositions*". In determining the taxable income for the purposes of French corporation tax, French tax law provides, therefore, that one should take into account only income produces in France and that which is attributed to the French tax jurisdiction by way of a bilateral tax treaty entered into by France[671].

More specifically, this "territorial" tax model applies to all French companies conducting business, either entirely or partially, outside French territory and to all foreign companies conducting business within French territory. Business profits earned abroad are, therefore, in principle, not taxable, nor are related losses deductible.

In tracing the contours of its taxing powers, France has, therefore, adopted a peculiar national provision allowing double taxation conventions to "take precedence" over domestic tax rules, even derogating to the implementation of the principle of territoriality with regard to income produced in a country with which France has

[669] It should also be recalled that Article 4 B CGI envisages three different and alternative criteria for the definition of the fiscal residence of an individual for the purposes of French tax law: a "personal criterion" (based on the "*foyer du contribuable*", i.e. the location of his/her family ties, and, as an alternative, on his/her "*lieu du principal séjour*" for at least 183 days during the tax year), a "professional criterion" (taking into account the exercise of the taxpayer's main professional activity in France) and an "economic criterion" (based on the place where the taxpayer's centre of economic interests lies).

[670] Melot, N., *Territorialité et mondialité de l'impôt: étude de l'imposition des bénéfices des sociétés de capitaux à la lumiere des expériences française et américaine*, cited above, 46.

[671] The third *loi de finances rectificative* for year 2009 has completed the "traditional" nature of France's territorial tax system with a second rule pursuant to which French tax is imposed on certain revenue deriving from real estate located in France.

concluded a bilateral tax treaty: in other terms, in all cases where a double taxation convention applies, France allows a "substitution" of territorial taxation in favour of worldwide taxation with regards to French residents who produce income in countries with which France has entered into a bilateral tax treaty.

More in detail, companies not residing in France are taxed on the income produced within French territory, whereas resident companies are exempted from taxation on their income produced abroad if and insofar as said income is effectively connected to an activity performed in foreign countries through a permanent establishment[672]. If a French business operates abroad, the possibility for France to levy taxes on the income produced abroad is, therefore, conditioned on the existence of a foreign permanent establishment and to the possibility to consider the foreign income as effectively connected to that permanent establishment[673].

In case of a double taxation convention being in place between France and the host country, in fact, France will have to verify whether not, pursuant to the terms of such convention, it is possible to identity a relevant fiscal presence of the French entrepreneur in the other contracting state. In case it is possible to ascertain the existence of such a presence, France will not tax the income deriving from the activity conducted abroad. If, on the other hand, pursuant to the terms of the applicable double taxation convention, it is not possible to consider the French entrepreneur's presence in the host country as sufficient, France might theoretically be able to levy taxes on the income produced abroad, if its own domestic tax law allows France to do so.

In case there is no double taxation convention in place between France and the host country where the French entrepreneur operates, France will implement its own domestic tax provisions, thus verifying whether or not the activity performed abroad by the French entrepreneur constitutes an activity that, pursuant to Section 209-I of the French Income Tax Code, can be considered as taxable.

French legal scholarship has developed two different interpretations of the above-mentioned provisions of Article 209-I CGI, given that there is still no unanimous

[672] Melot, N., *Territorial and worldwide tax systems: should France adopt the U.S. system?*, in International Journal, 2004, 1, 47; Pouletty, M., Smith, N., *The territoriality principle as applied in Denmark, France and Hong Kong*, in Tax Planning International Review, 2005, 1, 89.

[673] It must, however, be highlighted that, pursuant to French domestic tax law, the notion of "permanent establishment" is considerably wider than the common notion of "permanent establishment" approved by the OECD (and by the majority of Western countries that are members of the OECD). The French "permanent establishment" concept, in fact, goes beyond the traditional distinction between "physical permanent establishment" and "personal permanent establishment", also considering whether or not the enterprise residing in France puts in place a complete cycle of services or commercial transactions in a foreign country in order to verify the actual presence of a permanent establishment in that country.

agreement on the fact that such provisions lead to the implementation, with regard to companies, of a strictly territorial tax system[674].

Some authors have, in fact, argued that France has adopted a fiscal model based on worldwide taxation of corporate income of the enterprises located within French territory, at least with regard to those enterprises' passive income. More in detail, according to these authors, French companies conducting business in France would be levied taxes not only on their income having its source in French territory, but on their foreign-source income as well. According to this view, French tax law, much like Italian tax law, would entail a distinction between foreign companies and French companies, by way of which foreign companies are subject to corporate taxation on their income having source within French territory and French companies would be taxed on all of their passive income, wherever originated, and on their active income having its source within French territory[675].

Adhering to this view would imply the denial of the "purely territorial" character of French corporate tax law, arguing for a "hybrid" definition of "territoriality", a sort of "territoriality *à la française*" or a sort of "tempered worldwide tax model", where French companies are taxed on their worldwide income, but, in line with the overall territorial nature of the French tax model, an exemption from French tax base is granted to resident corporate subjects with regard to all of their foreign-source income[676].

However, the literal wording of the tax provisions cannot but lead to adhering to the theory which defines the French tax system as "purely territorial" with regard to corporate income: foreign companies are taxed only on their French-source income and an exemption from French income tax is provided for French companies on their income that they produce abroad through establishments or activities ("*entreprises exploitées*") located in foreign territories.

On the other hand, French administrative and judicial practice has traditionally developed a distinction between the extension of French taxing powers applicable to foreign companies and French companies, it being noted that French corporate tax law defines corporate residence on the ground of the company's legal seat, following the so-called "incorporation principle". Once again, therefore, attention cannot but shift to the

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[674] Melot, N., *Territorialité et mondialité de l'impôt: étude de l'imposition des bénéfices des sociétés de capitaux à la lumiere des expériences française et américaine*, cited above, 46.

[675] Gest, G., Tixier, G., *Manuel de droit fiscal*, Paris, 1998, 251.

[676] Melot, N., *Territorialité et mondialité de l'impôt: étude de l'imposition des bénéfices des sociétés de capitaux à la lumiere des expériences française et américaine*, cited above, 474. French domestic law generally does not provide for credit for foreign taxes, which means that income subject to foreign tax that is not exempt from French taxation under the French "territorial" tax regime is taxable net of foreign tax paid. However, most tax treaties entered into by France provide for a credit mechanism, which generally corresponds to the withholding tax paid in the source country, though capped at the French tax actually due on such net income.

definition of "residence" for fiscal purposes, which becomes the real "key-concept" in defining the extension of a state's taxing powers.

Whereas, according to French tax law, an individual is considered, for fiscal purposes, as residing in France if he/she has his/her permanent home therein or is physically present in the country for at least 183 days, with regard to companies, France has shifted from a system based on the mere "principle of incorporation" as a criterion for identifying corporate residence, according to which a company was considered as fiscally resident in the country where it was registered, to a sort of "hybrid" system. In fact, under current French law, a company is considered as fiscally resident in France if and insofar as its legal seat ("*siège*") is located in French territory, but also if its place of effective management ("*siège social effectif*") is located within French territory. More in detail, according to French tax authorities and jurisprudence, the place of effective management is located in the country where the management discretion is exercised[677]. Therefore, even though this analysis is generally conducted on a case-by-case basis, the place of effective management, under French tax law, will generally coincide with the place where the directors conduct the board meetings[678].

It should, however, be noted that, for decades, the question of corporate residence, in the context of French law, was seen as considerably less important for the purposes of taxation, since France still adheres to a strictly territorial approach with regard to corporate income taxation, according to which a company doing business in France, regardless of whether or not should be considered as fiscally resident in France, is taxed only on the income deriving from "French operations"[679].

It is also evident that the core of the doctrinal debate on which nature should be attributed to the extension of French taxation with regard to companies - either worldwide or territorial - is the interpretation of the words "*entreprises exploitées*" enshrined in Article 209-I CGI, constituting the threshold indicating when and to what extent foreign and resident corporations may be taxed on their active income in and by France. Notwithstanding its evident importance for the purposes of French tax law, this notion is not expressly defined by French law.

French jurisprudence, and, in particular, the case law developed by the *Conseil d'Etat*, has progressively substituted the notion of "*entreprise exploitée*" with the concept of "habitual exercise of a commercial activity", which means that putting in place an investment giving rise to passive income cannot imply that the person upon whom the

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[677] Avi-Yonah, R.S., Sartori, N., Marian, O., *Global perspectives on income taxation law*, cited above, 135.
[678] Lescot, M., *France issues Circular on branch tax exemption*, in Tax Notes International, 1998, 3, 77.
[679] Avi-Yonah, R.S., Sartori, N., Marian, O., *Global perspectives on income taxation law*, cited above, 135.

income accrues is engaged in a commercial activity in French territory, thus limiting the notion to active income only[680].

More in detail, French courts generally consider as "exercising commercial activity" for the above-mentioned purposes all non-resident companies holding an establishment in French territory or conducting therein a "commercial cycle", where, according to the French tax administration, a "*cycle commercial complet*" ("complete commercial cycle") corresponds to a "*série d'opérations commerciales, industrielles ou artisanales dirigées vers un but déterminé et dont l'ensemble forme un tout cohérent*"[681] and the activity must be "complete", in the sense that it is not sufficient for the activity in question to have just contributed to the production of the income, but it must have directly led to the production of such income itself and by itself. The test is less strict in case the activity in question is performed by a non-resident company through an establishment located in French territory: in that case, in fact, it is generally considered sufficient for that establishment to contribute to the active production of the income in order for that income to be taxable in France[682].

French law does not provide for detailed rules concerning how to determine the source of corporate income. Pursuant to section 164B-I of the *Code général des impôts*, "*sont considérés comme revenus de source française […] les revenus d'exploitation sises en France*". Besides this general statement, the conditions for income to be taxed in France are determined by case law and administrative guidelines. There are three alternative criteria determining whether a business activity is carried out in France: existence of an "*établissement*" (establishment), of a "*représentant*" (agent) acting on behalf of the company, existence of a "*cycle commercial complet*" (complete business cycle) separate from the other activities of the company.

It should also be highlighted that, in practical terms, foreign companies are subject to tax not only on their income originated within French territory, but also on their passive income (dividends, royalties, interest…) having their source in France, regardless of such income being linked or attached to an enterprise conducted in France. Such passive income is, in fact, subject to withholding taxes at source, either definitive or not, calculated on their gross amount[683]. The question is whether or not these levies are autonomous from French corporate taxation, constituting a sort of "separate taxation",

[680] Melot, N., *Territorialité et mondialité de l'impôt: étude de l'imposition des bénéfices des sociétés de capitaux à la lumiere des expériences française et américaine*, cited above, 250.
[681] Doc. adm. 4-H 1412, n. 18-20, 1 March 1995, cited by Melot, N., *Territorialité et mondialité de l'impôt: étude de l'imposition des bénéfices des sociétés de capitaux à la lumiere des expériences française et américaine*, cited above, 254.
[682] Melot, N., *Territorialité et mondialité de l'impôt: étude de l'imposition des bénéfices des sociétés de capitaux à la lumiere des expériences française et américaine*, cited above, 255.
[683] Articles 119-*bis*, 125A, 182B and 244-*bis* CGI.

which, therefore, can escape the general rules regulating French corporate taxation as described above, or simply constitute a different way to collect corporate taxes[684]: the answer to the question leads to understanding whether or not the "territorial criterion" developed by general French corporate tax law is derogated. Such withholding taxes are generally considered as autonomous and separated from general French corporate taxation, with corporations being subject, on one hand, to corporate taxation determined (in absence of any applicable tax treaty) on the ground of income produced in the context of the enterprises conducted in France and, on the other hand, to withholding taxes, separate from corporate taxation, on certain French-source items of passive income, even in absence of any related enterprise activity being conducted in France.

The "other side of the coin" of the territorial nature of French corporate taxation is constituted, as predictable, by the prohibition for French companies to have the losses incurred abroad taken into account for the purposes of diminishing their French tax liability: in general terms, resident and non-resident corporations which have suffered losses through an "*entreprise exploitée*" in a foreign country cannot deduct such losses from their profits which are taxable in France[685]. Thus, France realises symmetry of tax treatment of positive and negative items of income, which is typical of territorial income tax models[686].

3.1. French deviations from territoriality.

As highlighted at the outset, in recent times, the French lawmaker has enacted provisions enhancing, to a certain extent, the territorial characters and nature of France's tax system. Previous French law, in fact, used to provide for several regimes derogating from the territoriality of French corporate taxation with rules providing for favourable options for the corporate taxpayers.

One of said provisions concerned the so-called "*régime du bénéfice mondial simple*" and the so-called "*régime du bénéfice mondial consolidé*", which were repealed in 2011 because of their particularly burdensome nature, on an administrative level, both for the

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[684] Melot, N., *Territorialité et mondialité de l'impôt: étude de l'imposition des bénéfices des sociétés de capitaux à la lumiere des expériences française et américaine*, cited above, 87.

[685] It should be noted, however, that, pursuant to Article 39-*octies* CGI, French companies establishing a commercial plant in a foreign country may constitute a tax-suspended "provision" related to the losses suffered by that plant or establishment in foreign territory.

[686] However, if the losses suffered by French companies in the context of their "*enteprises exploitées*" in a foreign territory are not directly deductible from the corporate profits which are taxable in France, they may nonetheless be taken into account as an effect of the rules concerning depreciation of those French companies' participations in the foreign business activity, even though this possibility largely depends on the possible effects played by an applicable double taxation convention.

State and for taxpayers. The regimes at issue basically allowed companies subject to corporate taxation in France to opt, by way of an agreement with the tax authorities, for retaining their "worldwide fiscal unity", thus being taxed on all of the results of their "*exploitations*", both direct and indirect, and conducted both in France and in foreign territories[687].

The main advantage which was granted by those regimes was the possibility for French companies to deduct from their French profits losses and expenses incurred abroad by their subsidiaries ("*filiales*") and permanent establishments, with considerable tax savings for the companies concerned.

The "*régime du bénéfice mondial simple*" allowed French companies to determine their French tax base with reference to the French-source profits and the profits from "*exploitations directes*" conducted outside French borders, thus basically applying to bodies corporate the same income tax rules applicable to individuals: simple and unadulterated worldwide taxation, with the possibility for French companies to deduct from their French tax bases the taxes paid abroad in relation to the "foreign component" of their tax base. A system which was quite similar to the current Italian one.

On the other hand, the "*régime du bénéfice mondial consolidé*" was a sort of "extension" of the above-mentioned "*régime du bénéfice mondial simple*". It entailed an exception to territorial corporate taxation, allowing French companies operating at the international level to consolidate their profits which would have been normally taxed in France with their profits deriving from "*exploitations directes*" conducted outside French territory and also with their profits deriving from "*exploitations indirectes*", regardless of them being conducted in France or abroad. The notion of "*exploitations indirectes*" included, in particular, the French companies' share of the profits of the foreign companies participated by French corporate taxpayers, subject to certain holding thresholds.

Another regime allowing for a partial derogation from territorial taxation was the one concerning the possibility for French small and medium-sized enterprises (which were *de facto* excluded from the scope of application of the above-mentioned "*régimes du bénéfice mondial*") to enjoy consolidation, for tax purposes, of their foreign losses. Pursuant to said regime, small and medium-sized enterprises could, under certain conditions, deduct the losses suffered abroad by their subsidiaries and/or establishments from their French profits[688]. The measure was repealed in 2014.

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[687] Former Article 209-*quinquies* CGI.

[688] The effects of the regime were temporary, since the amounts corresponding to the deducted foreign losses were progressively reintegrated into the SME's taxable profits.

That being said, it should also be noted that French tax law still provides several - though more limited - exceptions to the general "territorial" nature of corporate taxation. Some examples are, for instance, the granting of the possibility of a "worldwide tax consolidation" (the so-called "*regime des groups fiscalement intégrés*"), the possibility of a deduction for contributions sent by resident companies to foreign related companies, CFC rules[689], etc. Furthermore, Article 209-C of the *Code général des impôts* provides that, in certain conditions, small and medium-sized enterprises may deduct losses incurred by foreign permanent establishments or foreign subsidiaries.

Moreover, French groups of companies are entitled to opt for the consolidation of a domestic parent and any 95%-or-more domestic subsidiaries (so-called "*intégration fiscale*"). As an exception to the principle of territoriality that generally shapes the entire French tax system and according to which active income is taxable in France only if its attributable to a French trade or business (mainly a branch or dependent agent), groups may also obtain the consolidation of a domestic corporation and its foreign branches and its 50%-or-more domestic or foreign subsidiaries ("*bénéfice mondial et consolidé*"). From 2009, small-sized or medium-sized corporations (with less than 2.000 employees) may opt for the deduction of losses of foreign branches or 95%-directly-held foreign subsidiaries. Such losses are recaptured as and when profits are made by such entities, and in any case no later than five years thereafter.

According to French tax law, 95% of the dividends received by a French company from one of its subsidiaries are exempt from corporate income tax - provided that the distributing subsidiary is located in a "non-black list" country and that the French holding company has held at least 5% of its share for a minimum period of two years - whereas 5% of those dividends remain taxable at the standard corporate tax rate[690]. This exemption applies to capital gains arising from the sale of shares in a subsidiary if said shares had been held for at least two years before being sold.

An issue of compatibility with European Union law has been raised with regards to the interaction between the French participation exemption scheme and the French group-consolidation regime. In fact, in case of a dividend distribution within a tax-consolidated group, of which only companies or permanent establishments established in France can be part of, the 5% portion of distributed dividends which is taxable under

[689] For an overview of the French CFC tax regime, compared with the Italian and UK regimes, see paragraph 5 hereinafter.

[690] It is generally believed that, in the absence of a specific rule disallowing the deduction by the French holding company of the expenses linked to its shares in the subsidiary distributing the dividends, the 5% portion of dividends remaining taxable in France would reflect the expenses deducted by the French holding company with regard to the dividends that are exempted from corporate taxation.

French law was neutralised in the computation of the consolidated taxable income, effectively resulting in a full exemption of intra-group dividends from corporate taxation. The same advantage was not granted to groups of companies formed by foreign subsidiaries, which is not eligible for being admitted to the tax-consolidation scheme and, therefore, did not enjoy the advantage at issue.

The Court of Justice has dealt with the problem in its *Groupe Steria* judgement[691], where it ruled that fully exempting dividends received from French tax-consolidated subsidiaries and exempting only 95% of the dividends received from a subsidiary located in a EU Member State amounted to a discriminatory treatment infringing freedom of establishment.

Following this decision, France has recently modified its provisions on the tax treatment of certain kinds of dividend distributions received by French companies. As an effect of this amendment, starting from 2016, the portion of qualifying dividends that generally remains taxable under the French participation exemption regime (i.e. 5%) is no longer exempt with regards to distributions made within a French tax-consolidated group of companies. Consequently, only 1% of the distributed dividends are now considered taxable with regards to distributions made in the context of a French tax-consolidated group. The same applies also to dividends received by a member of a French tax-consolidated group from 95%-owned subsidiaries located in another Member State of the European Union or of the European Economic Area.

Notwithstanding all of the above, the most evident derogation from the general territorial nature of the French tax system is the anti-avoidance provision enshrined in Article 209 B CGI[692], aimed at preventing the abusive employment of interposed entities by French companies through CFC rules. The French CFC regime will be analysed in the continuation of the research, alongside the Italian and UK regimes and the provisions of the Anti-Tax Avoidance Directive.

4. The United Kingdom: a "worldwide" tax model leaning towards territoriality.

The United Kingdom's entire legal system has unique traits setting it apart from all other juridical orders of the world and even from all other common law systems such as the United States. Notwithstanding the fact that it lacks a written constitution, the UK

[691] Court of Justice of the European Union, 2 September 2015, C-386/14, *Groupe Steria*.
[692] Melot, N., *Territorialité et mondialité de l'impôt: étude de l'imposition des bénéfices des sociétés de capitaux à la lumiere des expériences française et américaine*, cited above, 684.

system comprises some "constitutional" norms or, at least, provisions with a "constitutional nature", such as the 1689 *Bill of Rights*, which, however, could be modified with a simple Parliamentary law.

Nonetheless, this does not seem to in any way rule out the relevance, in the UK common law juridical system, of a general principle essentially similar to the one the Italian legal order defines as "*capacità contributiva*" as far as income tax law is concerned, despite the fact that any actual mention of such a principle by British judges is on the whole infrequent[693-694]. However, since this principle is not enshrined in any constitutional norm, a tax not complying with the "*capacità contributiva*" general standard would not be considered as *per se* illegitimate in the UK legal order.

In other words, the existence of a general principle of "*capacità contributiva*" in the United Kingdom legal order can be inferred by way of interpretation and generalisation of the tax provisions enacted in the UK. However, such a principle does not rise to the level of a constitutional precept and, therefore, is not hierarchically superior to the provisions establishing - or in other ways concerning - taxes[695]. It follows that the principle at issue cannot be considered as a legally binding criterion or standard for the legislature, neither as a part of the taxpayer's rights. Therefore, the only test that judges can resort to in evaluating the fairness of a tax provision amounts to the check of the conformity between the tax established by law and its tax object.

As a general rule, a resident of the United Kingdom is subject to UK income tax on all his/her income worldwide wherever its source, whereas a foreign resident is only liable to UK income tax on income arising in the United Kingdom, with that individual not being charged to UK income tax on foreign source income.

With an important distinction between individuals and corporations.

A non-resident individual taxpayer will be taxable as trading or professional income on the profits of any trade carried on within the United Kingdom, as opposed to with the United Kingdom. When a trade is carried on within the United Kingdom, the profits are computed under the normal rules applicable to the calculation of residents' income. For these purposes, however, the maintenance of an administrative or

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[693] Barassi, M., *La capacità contributiva in una prospettiva comparatistica*, in Salvini, L., Melis, G. (eds.), *L'evoluzione del sistema fiscale e il principio di capacità contributiva*, Padua, 2014, 185.

[694] With regards to the reasons why it would not be correct to use the term "ability to pay" as a synonym or substitute for the Italian "*capacità contributiva*", see what was said in the previous chapters (Chapter II, paragraph 4).

[695] In lack of a written constitution, the supremacy of the Parliament is paramount and, therefore, taxes find their legitimate basis in the democratic consensus and representation. Limits to Parliamentary supremacy exist, but they are not of an "internal" nature, stemming essentially from the EU legal order, at least until UK's formal exit, and from the European Convention on Human Rights.

representative office (as opposed to a branch or permanent establishment) in the United Kingdom will not *per se* constitute trading within the United Kingdom[696].

On the other hand, for non-resident companies, even if they are trading within the United Kingdom, no liability to UK corporation tax arises unless that trade is carried on through a permanent establishment located in the territory of the United Kingdom and liability will be restricted to the chargeable profits from that permanent establishment[697]. If that is not the case, the non-resident company's liability to tax will not be to corporation tax, but rather to income tax, at the basic rate[698]: in other words, a non-resident company with income arising in the United Kingdom but not trading through a permanent establishment in the United Kingdom cannot be assessed to corporation tax, but may be subject to UK income tax[699]. Moreover, under Corporation Tax Acts 2009, Section 19, capital gains are chargeable to UK tax only if they arise from property associated with the trade carried on by the permanent establishment.

That being said, it should also be highlighted at the outset that, as we will see in further details in the following pages, an individual which is domiciled abroad and which resides in the United Kingdom may be taxed on his/her foreign income only if that income is remitted in the United Kingdom[700]: this is the so-called "remittance basis regime", according to which, as we will see, individuals who are resident but not domiciled in the UK can elect to pay tax on the remittance basis of taxation, thus paying income tax on income from the UK and capital gains on gains arising in the UK and only pay UK tax on their overseas income and capital gains if they are brought into the UK (even though, after a certain amount of years during which an individual has been resident in the UK, a charge will be imposed if that individual wants to continue enjoying the benefits of the remittance basis system).

As far as international double taxation relief is concerned, in case there is no bilateral tax treaty applicable, unilateral relief is granted by the United Kingdom by way of a credit against the UK tax equal to the foreign tax paid, limiting that credit to taxes that are similar to UK taxes against which the relief is claimed[701]. Although the credit method constitutes the general rule for the United Kingdom, the exemption method is

[696] Lee, N. (ed.), *Revenue law: principles and practice*, London, 2012, 484.
[697] Corporation Tax Act (CTA) 2009, Section 19 ("*The company's chargeable profits are its profits that are a) of a type mentioned in subsection (3), and attributable to the permanent establishment in accordance with sections 20 to 32*").
[698] Corporation Tax Act (CTA) 2009, Section 3 ("*The provisions of the Income Tax Acts relating to the charge to income tax do not apply to income if a) the company is UK resident, or b) the company is not UK resident and the income is within the chargeable profits as defined by Section 19*").
[699] This is frequently the case where a non-resident company owns investment property in the United Kingdom, thus giving rise to rental income. Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 1133.
[700] Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 461.
[701] Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 488.

nonetheless applied in respect of dividends received by resident parent companies from their foreign subsidiaries. Within the European Union, in fact, the tax laws of the majority of countries provide for some form a participation exemption (also known as "affiliation privilege") in order to prevent economic international double taxation on profits distributed by foreign subsidiaries to resident parent companies holding a specific amount of capital and/or voting power in said foreign subsidiaries.

Having established all of the above, it should also be highlighted that, in more recent times, the United Kingdom has been moving from a worldwide taxation system for resident companies to a more territorial tax system, in broad terms, pursuant to which the focus is mainly put on profits earned in UK territory[702]. The key-areas for the implementation of such a change of perspective are the introduction of a dividend exemption regime, together with the establishment of the so-called "elective branch exemption" and the reformation of the UK CFC regime. As recognised by economic studies, however, moving from worldwide to territorial taxation does not eliminate the need for CFC regimes and other anti-avoidance rules, on the contrary increasing their importance, especially since the "fiscal gap" between active and passive foreign income widens. Moreover, the UK fiscal system now features a full exemption for various classes of foreign-source dividends and allows domestic tax deduction for foreign-source expenses, similarly to most other territorial systems.

4.1. Residence, ordinary residence and domicile. The "remittance basis".

As far as individual income taxation is concerned, British tax law has traditionally entailed a well-grounded distinction, which is (or was) typical of the Anglo-Saxon tradition, between the three concepts of "residence", "ordinary residence", intended as the place where the individual customarily has his/her home, as the place where the person habitually lives, and "domicile", which is linked to the person's origin rather than the person's physical presence in a certain place[703].

More specifically, "ordinary residence" has been held to be the individual's residence based on the choice of abode that he/she adopted voluntarily and which forms part of that individual's life. A person may, therefore, be resident without being

[702] With regard to the 2011 budget, Chancellor George Osbourne proclaimed that the highest ambition for the British economy was to "have the most competitive tax system in the G20" and "be the best place in Europe to start, finance and grow a business". Along with tax rate reductions, the transition to a territorial tax system seems to have served British ambitions.

[703] Green, S., *Domicile and revenue law: the continuing need for reform*, in British Tax Review, 1991, 1, 21.

ordinarily resident in the United Kingdom and vice versa[704]. In some cases, liability to UK tax was, then, only imposed on individuals who were considered as ordinarily residing in the United Kingdom, whereas, in other cases, liability to UK tax arises if the individual is either resident or ordinarily resident.

The concept of ordinary residence has been abolished for tax years starting after 5 April 2013, with the introduction of a new statutory residence test, which has superseded the previous case-law-based approach and all previous rules and criteria on residence, and all reference in UK tax legislation to "ordinary residence" has now been replaced with reference to a unitary concept of "residence".

The statutory residence test determines whether an individual is resident or non-resident in the United Kingdom in a certain tax year, for the purposes of income tax, capital gains tax and inheritance tax, through a two-step approach, composed of the "automatic residence text" and the "sufficient ties test"[705].

The "automatic resident test" is met if the individual meets any of the following conditions: he/she is present in the United Kingdom for at least 183 days in a tax year; he/she has a home in the United Kingdom for more than 90 days and visits that home for thirty days in the tax year; he/she works full time in the United Kingdom for 365 days without a significant break and in any one tax year more than 75% of these days are in the United Kingdom. Residence is, on the other hand, automatically excluded if one of the so-called "automatic overseas tests" applies[706].

If an individual does not meet any of the "automatic resident tests" or if he/she meets any of the "automatic overseas tests", the so-called "sufficient ties test" must be considered, which are based on the existence of family ties, the availability of an accommodation, work ties, and so on.

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[704] HMRC guidelines (HMRC 6, paragraph 3.2) state that an individual will be considered as "ordinarily resident" in the United Kingdom if a) he comes to the United Kingdom voluntarily, b) his/her presence in the United Kingdom has a settled purpose and c) his/her presence in the United Kingdom forms part of the regular and habitual mode of the individual's life. It has also been suggested by HMRC that going to the United Kingdom to live and work for three years or more will establish a habitual mode of life in the United Kingdom. Furthermore, if a person goes to the United Kingdom with the intention of visiting regularly for at least four tax year, ordinary residence will be presumed from the outset. If there is no such intention, HMRC guidelines (HMRC 6, paragraph 7.5) provide that HMRC will consider ordinary residence will commence from the beginning of the tax year after the individual has visited the United Kingdom over four years. On the point, see Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 467.

[705] Prior to the introduction of the "statutory residence test", pursuant to Sections 831 and 832 of Income Tax Act 2007, in order for an individual to be considered as residing in the United Kingdom for UK tax purposes, he/she must have spent 183 days of the relevant fiscal year in the United Kingdom or have his/her only home in the UK, having spent at least thirty days there during the relevant fiscal year. The "183-day rule" is absolute, and will apply even if the days spent in the UK by the individual have been spent for exceptional circumstances.

[706] The automatic overseas tests are based on the following circumstances: UK residence is automatically excluded if i) an individual who has been resident in the United Kingdom for any of the previous three years spends less than 16 days in the United Kingdom; ii) an individual who has not been resident in the United Kingdom for any of the previous three years spends less than 46 days in the United Kingdom; iii) an individual works full time in a foreign country and spends less than 91 days in the tax year in the United Kingdom and less than 31 days where he/she works in the United Kingdom for more than three hours.

For income tax purposes, however, especially in the context of tax provisions operating with regards to transnational income, greater relevance is given to the concept of "domicile", since residence is generally considered as easier for the taxpayer to manipulate, being it strictly connected to factual elements that the taxpayer may more easily alter, such as the period of time spent in a certain country or the physical presence of the person. Which does not apply to domicile: in order for a person to be able to modify his/her "domicile of origin" in favour of another "domicile of choice", he/she must, in fact, demonstrate his/her intention to permanently and indefinitely reside in another country and his/her physical presence in that country[707].

The concept of "domicile" for tax purposes is not specifically defined by statutory law, but its meaning has been defined from the general law which has developed over time: an individual's domicile is generally the country that he/she regards as his/her home, where he/she has his/her closest ties[708-709].

An individual's "domicile of origin" - generally defined by reference to the domicile of his/her father at the time of his/her birth - is retained by that individual unless and until it is abandoned through the acquisition of a "domicile of choice": in that case, the domicile of origin could be "revived" only if the domicile of choice is later abandoned by the individual without him/her acquiring a new one.

A domicile of choice is acquired by simultaneously satisfying two conditions, i.e. the individual's physical presence in the territory of his/her election and his/her intention to permanently and indefinitely reside in that territory (which is automatically excluded by HMRC practice if there is an intention, on the part of the individual, to return to his/her country of origin or if there is an intention to leave the country of choice and live somewhere else[710].

For the purposes of UK taxation, an individual can never be without a domicile, which means that, if he/she is unable to satisfy the conditions for any domicile of choice, his/her domicile of origin would automatically apply, even if that individual has no continuing connection with the country of his/her domicile of origin[711].

Having established what "domicile" means for the purposes of UK income tax law, we must now analyse the impact of that concept of the delimitation of the United

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[707] The loss of a person's "domicile of choice" automatically leads to regaining his/her "domicile of origin".
[708] Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 471.
[709] A special rule on the definition of "domicile" applies in the United Kingdom for the purposes of inheritance taxes only: an individual is deemed to be domiciled in the United Kingdom if he/she has been resident for tax purposes for seventeen out of the preceding twenty years, with the actual domicile being disregarded and liability to inheritance taxation being determined as if the individual was an actual UK-domiciled person, becoming chargeable to inheritance taxation on the whole of his/her worldwide assets.
[710] Lee, N. (ed.), *Revenue law: principles and practice*, cited above. 472.
[711] Lee, N. (ed.), *Revenue law: principles and practice*, cited above. 472.

Kingdom's taxing powers with regards to items of income which are considered as somewhat "foreign". Reference should, therefore, be made to the so-called "remittance-basis taxation".

A foreign domiciled individual resident in the United Kingdom may claim to be taxed on the remittance basis, i.e. being chargeable to UK income tax only on his/her income received in the United Kingdom and on his/her foreign income exclusively if and insofar as that income is actually brought by the taxpayer to the United Kingdom[712]: unless foreign income is actually brought to or enjoyed in the United Kingdom there is no tax charge[713-714]. It follows that an individual which resides in the United Kingdom but does not have his/her domicile there, i.e. the so-called "non-domiciled resident", will be taxed exclusively on his/her income that is produced in the United Kingdom, whereas the "domiciled resident" will be taxed by the United Kingdom on his/her worldwide income, wherever accrued.

This is the reason why a considerable number of individuals have tried to transfer their residence to the United Kingdom, while maintaining their domicile elsewhere and producing a limited amount of income in UK territory, thus being able not to pay tax on their worldwide income in their country of residence (since they could not be considered as residing there any longer) and to pay a limited amount of tax in the UK, since, being "non-domiciled residents", they could be taxed only on the income produced in the territory of the United Kingdom. For all individuals trying to avoid the acquisition of a domicile of choice, it is, therefore, necessary to demonstrate that their period spent in the United Kingdom is for specific or limited purpose and that their long-term intention is to leave the United Kingdom; it is also necessary, according to HMRC practice, to preserve ties in the country of origin or develop ties elsewhere, indicating a lack of commitment to the United Kingdom.

As it has been shown, therefore, the analysis on the point of domicile and, consequently, on the non-remitted income being subject to UK tax is based on a factual and very "practical" examination.

As far as corporate residence is concerned, UK tax law mainly resorts to what has been defined above as the "legal seat" criterion. It should be highlighted that it is

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[712] UK tax law provides for similar mechanisms to apply also in the context of capital gains tax and inheritance taxes.
[713] However, in order to enjoy the benefits of taxation on a remittance basis, an individual who has been resident in the United Kingdom for seven out of the previous nine tax years must pay a special charge each year.
[714] It should be noted that, with effect from 6 April 2008, the taxation of UK resident individuals with a foreign domicile was profoundly changed, with a recast of the remittance basis so as to bring foreign income and capital gains into the scope of UK taxation in a much wider set of circumstance. Changes were also made to the taxation of offshore trusts by UK-resident foreign-domiciled individuals.

possible, under UK law, for a company to be "dual resident", i.e. to reside in more than one country.

Prior to 15 March 1988, in fact, any company was considered as a UK resident, thus being subjected to UK corporate income tax on its worldwide profits, wherever accrued, if its central management and control was located in the United Kingdom[715]. Central management and control was deemed to be located at the place where board meetings were held and not necessarily where the company was incorporated or registered[716].

After 15 March 1988, another corporate residence test was added to the traditional "control and management test", with attention being paid to the place of company incorporation[717]. Finally, under UK tax law, a company is considered as fiscally resident in the UK if it is incorporated under UK law but also, in case it is incorporated abroad, if its central management and control is located in the United Kingdom[718].

Therefore, the current "residence test" for companies operates to the effect that a company will be considered as residing in the United Kingdom if either it was incorporated there or, in the case of companies incorporated abroad, its central management and control is located in the United Kingdom[719].

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[715] Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 467.

[716] On the point, see the judgement rendered by the House of Lords on the *De Beers Consolidated Mines v. Howe* case in 1906.

[717] Corporation Tax Act (CTA) 2009, Section 14 ("*A company which is incorporated in the United Kingdom is UK resident for the purposes of the Corporation Tax Act. Accordingly, even if a different place of residence is given by a rule of law, the company is not resident in that place for the purposes of the Corporation Tax Act*") and Section 18 ("*This section applies to a company which is treated as a) resident in a territory outside the United Kingdom, and b) non-UK resident, for the purposes of any double taxation arrangements. For the purposes of the Corporation Tax Acts the company is a) resident outside the United Kingdom, and b) non-UK resident*")

[718] The main criterion on the point has been developed by the House of Lords' judgement on the *De Beers* case (House of Lords, *De Beers Consolidated Mines Limited v. Howe*, 17 April 1906), where the question was whether a company registered and having its main office abroad can be assessed in the United Kingdom on the grounds of having an office in London and its managers residing in the UK. The House of Lords rejected the "place of incorporation test" as the only parameter to determine corporate fiscal residence, asserting that "*a company resides for purposes of income tax where its real business is carried on*" and that "*the real business is carried on where the central management and control actually abides*". Another essential benchmark concerning the same issue is the judgement rendered by the House of Lords in the *Unit Construction* case (House of Lords, *Unit Construction co. Ltd. v. Bullock*, 30 November 1959). The case concerned three subsidiaries of a UK company which were registered in Kenya, where all board members were located as well. In order to use the losses suffered by the Kenyan subsidiaries against the parent company's profits, the UK company argued that the Kenyan directors did not exercise any actual discretion in the management of the subsidiaries and received all of their instructions from the UK head offices of the parent company. The House of Lords ruled that the subsidiaries were, in fact, all domiciled in the UK for fiscal purposes, concluding that "*only authorised […] management and control are relevant to an inquiry as to the residence of a company*". For a more detailed review of the cases, see Avi-Yonah, R.S., Sartori, N., Marian, O., *Global perspectives on income taxation law*, cited above, 134, and also Couzin, R., *Corporate residence and international taxation*, cited above, 25. However, according to HMRC guidelines, the place where the board of directors' meetings are held is not *per se* decisive for the purposes of UK tax law, since substantive management decisions must be taken in these meetings in order for them to be relevant for the purposes of determining a company's fiscal residence.

[719] In the *Wood v. Holden* judgement (England and Wales Court of Appeal, 26 January 2006), the British Court ruled that, if a foreign company's board meetings are held outside the United Kingdom, then the place of central management and control is considered to be outside the United Kingdom unless it can be shown that a UK resident subject had dictated or usurped the powers of the board. Later on, in the case of *Laerstate BV v. HMRC*

The result of this combination of factors has clearly led to a wide-ranging concept of "residence" and to a vast extension of UK worldwide corporate liability to tax for companies. In fact, companies incorporated in the United Kingdom will always be considered as residing in the United Kingdom for UK tax purposes and will remain UK resident even if control and management is exercised abroad, unless under the terms of a "tie-breaker rule" enshrined in a double taxation convention they would prove to be resident of another country. Furthermore, foreign incorporated companies may become resident in the United Kingdom if their central management and control is located in the United Kingdom[720].

A similar "central management and control test" applies to partnerships. Therefore, if the management and control of the business is exercised abroad, the firm is deemed to be non-resident even though individual partners may be resident in the United Kingdom; on the other hand, a partnership established abroad is treated as residing in the United Kingdom if it is managed and controlled in the United Kingdom[721]. However, since a partnership is generally not taxed in the United Kingdom as a separate entity, the individual partners' residence is more important for the purposes of UK taxation[722].

4.2. The UK Diverted Profits Tax.

With Finance Bill 2015, the UK Government has introduced a new anti-avoidance measure by way of a new tax, i.e. the so-called Diverted Profits Tax (DPT), which is intended to apply, from 1 April 2015, to large multinationals conducting business in the United Kingdom and escape UK taxation diverting profits from the UK by avoiding a UK taxable permanent establishment.

The measure seems to follow the purpose to ensure that income is taxed where it is generated, notwithstanding the practical difficulty to understand where the actual

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(UK First Tier Tribunal, 25 November 2009), the Judges have found that, while the board meetings took place outside the United Kingdom, the high-level decisions were not taken by the board, but rather by one of the directors, predominantly in UK territory, which led the Court to rule that the company's central management and control was in the United Kingdom.

[720] The traditional "*De Beers* doctrine" continues to apply to foreign corporations, as clarified by HMRC guidance in a note rendered in July 2010.

[721] Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 468.

[722] HMRC will, therefore, "look through" a partnership to the residence of its individual members in order to determine the tax liability of each partner. Therefore, as far as UK-source income of a partnership is concerned, single members of that partnership are subject to income tax irrespective of the fact that they are resident in the United Kingdom. With regards to income of a partnership having its source outside the United Kingdom, members of the partnership who are UK-resident are subject to tax in the United Kingdom on their share of that income, whereas partners who do not reside in the United Kingdom for tax purposes are not taxed on their share of that income.

"source" of the income lies and the possible confusion between the concepts of "production of the income" and "consumption of wealth". However, the application of the Diverted Profits Tax depends on the assessment of an elusive behaviour on the part of the taxpayer and does not have a "systematic" purpose, being it more aimed at preventing tax avoidance. It constitutes, nonetheless, a new example of "extraterritorial" exercise of taxing powers on the part of a state, through a mechanism that, to a certain extent, is relatable to that of the CFC regime.

Diverted Profits Tax is charged, with a rate higher than the ordinary UK corporate tax rate, in situations where the taxpayer's behaviour challenges the traditional connecting criteria defined by law to justify the exercise of taxing powers, on the part of the source state, with regard to a certain item of income, by avoiding the creation of a UK taxable presence[723].

The DPT charge applies in two situations[724]. In the first case, it requires there to be a company that is not resident in the United Kingdom and another subject which is carrying on activity in the United Kingdom in connection with the supply of goods or services by the non-resident company to customers in the United Kingdom. Therefore, in case a non-resident UK company carries on an activity in the UK in connection with the supply of goods or services to UK customers, conducting a business activity that generates income within UK territory, and it is reasonable to assume that any of the activity is designed to ensure that the foreign company does not have a UK permanent establishment (the so-called "avoided permanent establishment"), the charge applies.

In this case, the Diverted Profits Tax is applied on the amount that is just and reasonable to assume would be the chargeable profit, if computed in accordance with the principles regulating attribution of income to permanent establishments, according to OECD practice, had the "avoided permanent establishment" been a UK permanent establishment through which the non-resident company carried on the relevant trade in the United Kingdom[725].

More specifically, in order for the rule to apply, it must be reasonable to assume that either or both of the following conditions are met: the so-called "mismatch condition" or the "tax avoidance condition".

[723] Diverted Profits Tax, however, does not apply to small and medium-sized enterprises, with a threshold of 10 million GBP.

[724] The assessment and collection of the Diverted Profits Tax is based on a duty on the companies concerned to notify HMRC within three months of the end of an accounting period where it is reasonable to assume that diverted profits might have arisen.

[725] The rule, however, does not apply where the total UK sales revenue of the company together with any connected companies in a twelve-month accounting period are less than ten million pounds.

The "mismatch condition" requires an agreement to be made between the foreign company and another person where one of the subjects is directly or indirectly participating in the management, control or capital of the other or another person is directly or indirectly participating in the management, control or capital of both subjects, thus resulting in an effective tax mismatch between the foreign company and the other person which is not mirrored by an effective economic substance. The "tax mismatch" conditions is considered as met if the foreign tax is lower than 80% of the equivalent UK corporation tax.

The "tax avoidance condition" is considered as met if, in connection with the supply of goods or services, arrangements are in place with the purpose (even if not exclusive purpose) to avoid a charge to corporation tax in the United Kingdom. This analysis must be conducted on an objective basis, with regard to the full context and facts of the circumstances.

Secondly, the Diverted Profits Tax is charged on a transactional basis, making reference to transfer pricing rules, i.e. where a company puts in place arrangements lacking economic substance: in case a subject, irrespective of it being or not a UK-resident, enters, together with a UK-resident, into a transaction which is deprived of an underlying effective economic substance, with the purpose to divert profits from the United Kingdom to other countries, the DPT is charged on the amount constituting the difference between what that taxpayer has actually paid and what ought to be paid in "normal conditions", according to criteria based on the arm's length principle, on "reasonableness" and on the common practice of business models. In other words, the rule applies where both an "*effective tax mismatch outcome*" results and an "*insufficient economic substance*" condition is met.

It is particularly important to highlight that the Diverted Profits Tax is a separate tax from UK income or corporation tax, which is why any payment of Diverted Profits Tax is not relevant in any way for the purposes of calculating income or corporation tax. Which means that no deduction or relief is allowed with regard to the Diverted Profits Tax paid by the company and that no amount paid by the company can be treated as a distribution.

The European Commission has made known that it is examining the rule at issue in order to ensure that the measure is compliant with European Union law and with the Internal Market rules. It has been suggested, for instance, that the rule might have a negative impact on the Treaty freedom to provide service and that the higher rate of Diverted Profits Tax compared to the regular UK corporate income tax rate might be

seen as a discrimination or restriction imposed on companies established in the European Union outside the United Kingdom.

Some of the first commentators of the relatively new UK tax measure have argued that the Diverted Profits Tax runs the risk of not being considered as sufficiently targeted to "wholly artificial arrangements" exclusively, thus failing the "*Cadbury Schweppes* test", as described in previous pages of the research, especially since the above-mentioned "lack of economic substance test" does not seem to require any examination of the purposes of the arrangements at issue[726].

5. Derogations from territorial taxation and extensions of worldwide liability to tax: CFC regimes in Italy, France and the United Kingdom.

As has been shown above, in general terms, applying either one of the traditional system of worldwide taxation based on personal connection to the territory (e.g. residence, nationality…) or the traditional model of territorial taxation based on the place of production of the income, a country should not be able to tax income produced by a non-resident in a place located outside its territory: in that case, in fact, both "subjective" and "objective" connecting criteria would essentially be missing and the exercise of taxing powers would have a strong "extraterritorial" nature, which would go against common international practice and, possibly, as was shown in the second chapter of the research, also European Union law.

However, in order to curb tax avoidance by resident companies possibly diverting passive investment income to offshore corporations located in tax havens, almost all European Union Member States resort to some instruments allowing them to levy taxes also on income produced abroad by subjects that do not formally reside within their territory and that have not produced the relevant income within their territory, thus entailing an extraterritorial exercise of taxing powers[727]. The implementation of such rules has been strongly suggested by the OECD as well[728].

[726] Self, H., *The UK's new Diverted Profits Tax: compliance with EU law*, in Intertax, 2015, 4, 333.

[727] Maisto, G., Pistone, P., *A European model for Member States' legislation on the taxation of controlled foreign subsidiaries (CFCs)*, cited above, 503.

[728] On the point, see the OECD 2015 Final Report developed in the context of the Base Erosion and Profit Shifting Project on "*Designing effective Controlled Foreign Company rules*", published October 5, 2015. The Report sets out recommendations which are theoretically designed to ensure that jurisdictions choosing to implement CFC regimes have rules that would be able to effectively prevent taxpayers from shifting income into foreign subsidiaries. The report concerns the definition of a CFC, the topic of CFC exemptions and threshold requirements, the definition of "income" for the purposes of CFC regimes, the ways to compute the relevant CFC income and to properly attribute to resident companies and the prevention and elimination of double taxation. Acknowledging that each country generally responds to different policy objectives, such recommendations attempt to provide flexibility to implement CFC rules in a manner consistent with the policy objectives of their

This is the mechanism around which Controlled Foreign Companies (CFC) regimes are built: the controlled foreign company is, thus, either treated as a branch of the resident parent company, allowing taxation of said subsidiary's profits on an accrual basis in the parent company's hand, or it is deemed to have distributed its profits every year to the parent company, allowing for the same current taxation in the country where the parent company is located.

As a result of the wide evolution of the CFC regimes, the distinction between global and territorial jurisdictions seems to have lost much of its importance. On one hand, in fact, territorial jurisdictions seek to tax passive income earned by their residents from foreign sources through the operation of CFC rules and many have endorsed worldwide taxation of individuals. On the other hand, countries with worldwide tax systems tend to allow deferral for active income earned by their residents through controlled foreign companies and the recent trend has been to go even further and exempt dividends distributed by CFCs to their parents.

National tax provisions concerning controlled foreign companies share a common core, but are partially different from one another[729], even though the latest developments of European Union law have led to a considerable level of uniformity of such regimes amongst Member States' tax laws. As it has been highlighted in the previous chapter of the present research, the Court of Justice has, in fact, narrowed the possibility to implement such legislations under the freedom of establishment to "*wholly artificial arrangements*", as such regimes subject parent companies holding foreign subsidiaries to less favourable tax treatment than parent companies of domestic subsidiaries[730]. The Court, therefore, requires an analysis for whether or not abuse is present on an individual case-by-case basis in order for a CFC regime to compatible with European Union law. Nonetheless, as it was shown in the second chapter of the research, in a

tax systems and the "*international legal obligations of the country concerned*": a specific part of the Report is, in fact, dedicated to the compatibility of CFC regimes with European Union law.

[729] For a comparative analysis, see Cipollina, S., *Profili evolutivi della CFC legislation: dalle origini all'economia digitale*, cited above, 356; Arnold, B.J., *The taxation of Controlled Foreign Corporations: an international comparison*, Toronto, 1986, *passim*; Kane, M.A., *The role of Controlled Foreign Company legislation in the OECD Base Erosion and Profit Shifting Project*, in Bulletin for International Taxation, 2014, 2, 321; Dourado, A.P., *The role of CFC rules in the BEPS initiative and in the EU*, in British Tax Review, 2015, 1, 340; Stizza, P., *La disciplina fiscale delle Controlled Foreign Corporations in Italia, Francia e Regno Unito*, cited above, 1403.

[730] Court of Justice of the European Union, 12 September 2006, C-196/04, *Cadbury Schweppes*. It should be noted, however, that the more recent *SGI* case (Court of Justice of the European Union, 21 January 2010, C-311/08, *Société de gestion industrielle*) suggested that necessary measures against base erosion may legitimately distinguish between domestic and cross-border situations if it would make no sense to apply them in purely domestic circumstances (as CFC legislation makes no sense as regards domestic subsidiaries, which are fully subject to domestic corporation tax).

number of more recent cases, the Court has accepted a general presumption of abuse in entire categories of cross-border circumstances[731].

The most recent chapter of the evolution of CFC regimes in the European Union context is constituted by the enactment of the recently adopted Anti-Tax Avoidance Directive, which, confirming the most recent trends of the Court of Justice's case law on the point[732], explicitly allows Member States to derogate from a rigorously territorial structure of the extension of their taxing powers in favour of the application of worldwide liability to tax to items of income (and taxpayers) that are not directly connected to the territory of the taxing country. As highlighted in the previous chapter of the present research[733], Articles 7 and 8 of the Anti-Tax Avoidance Directive provide general standards to which Member States' CFC tax regimes are called to adhere, so as to endow Member States with a system to counter aggressive tax competition and international tax avoidance in a way that could minimise the impact of the rules at issue on the fundamental freedom of establishment.

5.1. The Italian experience.

Italian tax rules on Controlled Foreign Companies have, over time, undergone several changes, frequently as the result of drives coming from international organisations, i.e. essentially OECD, and from European Union law, either by way of judgements of the Court of Justice or by way of directives or recommendations from the EU legislature. The latest reform dates back to 2016 and have been enacted by Legislative Decree n. 147/2015 and Italian Law n. 208/2015 in order to "align" the Italian CFC regime to international standards[734].

Italian scholars have long debated on the rationale behind the CFC provisions.

According to some of them, the purpose of the regime would be to prevent undue tax deferrals on the part of the companies concerned as a result of the decisions of the managers of the foreign company to delay the distribution of dividends to the shareholders, including those residing in Italy[735]. Others have, on the other hand, stressed

[731] See, for example, *Van Hilten* and *Thin Cap Group Litigation order*.
[732] On the point, see the previous chapter, at paragraph 5.
[733] See Chapter III, paragraph 5.
[734] Provisions on the tax treatment of controlled foreign companies were introduced for the first time in Italian tax law with Italian law n. 342/2000, which provided for the insertion of a brand new Article 127-*bis* in Presidential Decree 917/1986 (the Italian "Income Tax Code"). The rule was subsequently modified in 2003, with the extension of its scope of application to "related companies" as well. In 2009, then, the regime was modified with regards to the requirements for the rule to apply.
[735] Stevanato, D., *Controlled foreign companies: concetto di controllo e imputazione del reddito*, in Rivista di Diritto Tributario, 2000, 3, 790; Fantozzi, A., Paparella, F., *Lezioni di diritto tributario dell'impresa*, cited above, 246.

the existence of a particular analogy of nature and purpose between the CFC regime and the Italian rules on fictional relocation of income and companies (“*esterovestizione*”), with CFC provisions aiming at subjecting to taxation all item of income that are apparently produces outside Italian territory, even though they are generated by way of a business activity directed and managed in the territory of the State[736]. Finally, other authors have argued that the Italian CFC regime would not be characterised by purposes of mere prevention of tax evasion and/or avoidance, but that it would be aimed at guaranteeing capital export neutrality, granting substantially equal treatment between those who produce income in foreign territories and those who produce income within the territory of the State[737].

It should also be highlighted that the Italian Supreme Court (“*Corte di Cassazione*”) has recently ruled in favour of the compatibility of the Italian CFC regime with the Treaty freedom of establishment enshrined in Articles 49 and 54 TFEU, as interpreted by the Court of Justice of the European Union in its *Cadbury Schweppes* judgement[738].

The Supreme Court recognised that, according to the Court of Justice’s jurisprudence, CFC regimes can be considered as compliant with the freedom of establishment if they are specifically addressed at circumstances where either the controlled foreign company is an artificial arrangement aimed at avoiding taxes or the controlled foreign company is not really located and established in the country of its formal residence or does not pursue any actual business purpose. Starting from this assumption, the Court found the Italian CFC regime to be compliant with the above-mentioned principles, since it allows the taxpayer to provide proof as to the circumstances that are necessary to demonstrate such conditions, with the consequent possibility to be exempted from the application of the regime.

Currently, Article 167 of Presidential Decree 917/1986 essentially establishes that a taxpayer residing in Italy for fiscal purposes is subject to tax on the income produced by certain controlled foreign companies in which said resident taxpayer, directly or

[736] Cordeiro Guerra, R., *Riflessioni critiche e spunti sistematici sulla introducenda disciplina delle Controlled Foreign Companies (art. 127-bis del T.U.I.R.)*, in Rassegna Tributaria, 2000, 6, 1399; Greggi, M., *Recenti sviluppi e questioni di compatibilità comunitaria delle disposizioni di contrasto al fenomeno della cosiddetta esterovestizione societaria*, cited above, 115.

[737] Ballancin, A., *Note ricostruttive sulla ratio sottesa alla disciplina italiana in tema di controlled foreign companies*, in Rivista di Diritto Tributario, 2008, 1, 27; Marino, G., *Il regime di imputazione del reddito dei soggetti partecipati residenti o localizzati in ‘paradisi fiscali’*, in Uckmar, V. (ed.), *Diritto tributario internazionale*, Padua, 2005, 928; Dominici, R., *Lo spirito della legislazione cfc e i suoi intrecci con la deducibilità dei costi verso paradisi fiscali*, in Dialoghi di Diritto Tributario, 2005, 2, 1190; Cipollina, S., *Profili evolutivi della CFC legislation: dalle origini all’economia digitale*, cited above, 356.

[738] Reference is made to the judgement rendered by the Supreme Court (*Corte di Cassazione*) on 16 December 2015, n. 25281.

indirectly, holds a dominant influence[739]. In this case, the income of the controlled foreign company is taxed directly on the Italian resident shareholder at the standard corporate income tax rate and according to the business income rules provided for by Italian tax law.

However, the losses incurred by the foreign company cannot be deducted of the income of the Italian shareholder, also because, pursuant to paragraph 7 of Article 167, the portion of the controlled foreign company's income which is taxed directly on the resident shareholder does not constitute part of that resident's shareholder general tax base, but is subject to separate taxation with the application of the average corporate tax rate. The resident taxpayer is, on the other hand, allowed to a proportionate deduction from the taxable amount of the attributed income of the taxes incurred abroad by the controlled foreign company.

The regime applies to controlled foreign companies located in countries or territories, other than Member States of the European Union or of the European Economic Agreement (with which Italy has entered into an agreement for the exchange of information), whose ordinary or special tax regimes lead to a nominal level of taxation that is less than half the nominal level of corporate income taxation in Italy.

Furthermore, the Italian CFC regime allows for the possibility, for the resident taxpayer, to be exempted from the application of said regime if proof is provided that either the controlled foreign company actually and effectively operates and trades on the market of the country or territory where it is located or that the result of the Italian-resident's participation in the foreign company does not lead to the localisation of income in a country with a more favourable tax regime. However, such possibility is not entirely granted if more than 50% of the controlled foreign company's income is of passive nature. In that case, exemption from the CFC regime can only be allowed if proof is given that that the result of the Italian-resident's participation in the foreign company does not lead to the localisation of income in a country with a more favourable tax regime.

The provisions of Article 167, however, also apply if the relevant controlled foreign company is located in a EU or EEA Member State if that company is subject to an effective (not nominal) taxation which is lower than half of the tax level which would be applied in Italy and more than half of its income is of passive nature. The application of the regime to EU/EEA controlled foreign company can be avoided if the taxpayer

[739] The relevant "control" threshold is determined pursuant to Article 2359 of the Italian Civil Code.

provides proof that the establishment located abroad does not constitute an artificial arrangement aimed at generating an undue tax advantage.

The current Italian CFC regime appears to be essentially in line with the general standards set out by the Anti-Tax Avoidance Directive. There are, nonetheless, some minor discrepancies that should be highlighted.

The first of these differences concerns the relevant definition of "control". On one hand, in fact, Article 7 of the Directive provides that, in order for the CFC regime to apply, the foreign entity has to be controlled by a resident subject holding a participation in the foreign company that must be higher than 50% of voting rights or rights of distribution. On the other hand, the Italian CFC regime, applying a definition of "control" which is the one provided for by Article 2359 of the Italian Civil Code, extends its application to situations characterised by a *de facto* control as well[740].

Secondly, the Anti-Tax Avoidance Directive specifies that the application of the CFC regime must be conditioned to the circumstance that the effective tax level in the country where the foreign company is established must be lower than 50% of the tax level which would be virtually applicable if the foreign company were considered as being resident of the country where the controlling company is established. However, the Italian CFC regime, as modified in 2015, provides that, in order to identify a country as a "favourable tax regime" for the purposes of the application of the rules at issue, the administration must refer (not to the effective level of taxation, but) to the nominal level of taxation of the state of residence of the controlled foreign entity, which must not be lower than 50% of the Italian nominal tax level.

Furthermore, the Anti-Tax Avoidance Directive establishes that, in case of application of the CFC regime, the controlling subject's tax base should only include the passive income attributable to the foreign entity, whereas Italian tax law provides for the inclusion of all of the controlled foreign company's income within the tax base of the resident controlling subject.

Notwithstanding all of the above, it should be recalled that Article 7 and 8 of the Anti-Tax Avoidance Directive are aimed at establishing minimum standards to which all Member States' CFC regimes must comply, which does not prevent such Member States to enact stricter rules, as far as such rules do not infringe European Union law and the fundamental Treaty freedoms. Which means that stricter rules such as the Italian

[740] Pursuant to Article 2359 of the Italian Civil Code, in fact, a company is considered as "controlled" by another company if that other company holds the majority of the votes in the controlled company's ordinary assembly or a number of votes which is sufficient to exercise a dominant influence in the controlled company's ordinary assembly or, finally, if it is under the dominant influence of that other company by virtue of specific and particular contractual bounds with it.

provisions described above do not necessarily imply that Italy has failed to comply with European Union standards.

5.2. The French experience.

France's CFC regime constitutes an evident derogation to the general territorial nature of the French tax system, according to which only profits generated in France are liable to tax. The regime appears to be quite similar to the newly modified Italian CFC regime: it entails a distinction between controlled foreign companies located within the European Union or within the territory of the European Economic Agreement, on one hand, and companies located in third countries, on the other hand. It also does not limit its application only to the foreign company's income of a passive nature.

France has been one of the first countries to implement fiscal CFC rules, also initially extending them to subjects operating in other EU Member States as well. Such rules, however, have been deemed as incompatible with the European Union legal order and Internal Market by the French judicature[741], which has led to a modification of these provisions, with the application of the French CFC regime to all foreign companies, wherever located, specifying that, in case the activity is located within the European Union, in order for the rules to apply the structure must be purely artificial and only aimed at obtaining a tax saving.

The French CFC regime has been modified in 2012, extending the tax treatment of companies operating in non-cooperative jurisdictions to companies operating in low-tax jurisdictions and shifting the burden of proof necessary to be exempted from the application of the regime at issue entirely on the corporate taxpayer[742], which is now required to demonstrate that the foreign company is carrying on genuine business activities in the foreign territory of its establishment and that the developed business structure has "main justifications" other than simple tax avoidance motives.

The French CFC regime is enshrined in Article 209 B CGI, which provides that, if a French corporate taxpayer owns, directly or indirectly, more than 50% of either the share capital or the voting rights or the "financial rights" of a foreign corporate entity

[741] *Conseil d'Etat*, 28 June 2002, *Société Schneider Electric*, which even precedes the Court of Justice's judgement on the *Cadbury Schweppes* case. On the point, see Maisto, G., Pistone, P., *Modello europeo per le legislazioni degli Stati membri in materia di imposizione fiscale delle società controllate estere (CFC)*, cited above, 193.

[742] Under the previous version of Article 209 B CGI, the burden of proof rested entirely on the French tax authority, and CFC rules applied where either at least 20% of the CFC income was passive, or at least 50% of the CFC income was either passive or derived from performing intragroup services. In order to combat tax avoidance and reduce uncertainty for the taxpayer, France has now eliminated these thresholds and shifted towards a legislation that is more focused on a "substance over form" approach.

benefitting from a "privileged tax regime" in the country where it is located[743], that French corporate taxpayer will be considered as if it has received "deemed dividends" from the foreign entity, in proportion to its participation in the latter, and such dividends will be taxed in the hands of the French-resident corporate taxpayer.

However, as mentioned above, the regime entails two kinds of "safe harbour rules", which were introduced in order to ensure that the regime complies with EU law, as interpreted by the Court of Justice.

First of all, in case the foreign entity is located within the European Union, a "safe harbour rule" applies, whereby Article 209 B can be applied exclusively if the participation held by the French corporate taxpayer in the foreign EU-located entity constitutes an artificial scheme with the purpose of circumventing French taxation.

Moreover, in case the foreign entity is located in a third country outside the European Union, CFC provisions may not be applied if the French corporate taxpayer demonstrates that the main purpose and effect of the operations conducted by the controlled foreign company is not to enact an undue transfer of profits to a tax-privileged jurisdiction and that said foreign company conducts an effective industrial or commercial activity in the jurisdiction where it is located ("*une activité industrielle ou commerciale effective exercée sur le territoire de l'Etat de son établissement ou de son siege*")[744]. This is the so-called "general safe harbour rule".

In light of the above, it would appear that the French CFC regime already complies with the standards set out by the Anti-Tax Avoidance Directive. In fact, the relevant definition of "control" provided by French law is strictly coinciding with the one provided by the Directive; the regime already entails carve-outs and specific rules for controlled foreign companies located in the territory of the European Union, with a different burden of proof on the taxpayer.

5.3. The UK experience.

[743] Such non-French entity is deemed as benefitting from a "privileged tax regime" in the jurisdiction where it is located if its effective tax rate in such jurisdiction is more than 50% lower than the effective French tax rate that would have been applicable "under normal conditions".

[744] Article 209 B, paragraph 3, CGI. The French provision expressly mentions tjhe object of the activity, taking a definitive position on a question that had given rise to an age-old debate between French judges, tax authorities and legal scholars on whether the possibility to escape from the scope of application of the CFC regime should be granted provided that the taxpayer demonstrates that the object of the activity is effective and not aimed at avoiding French taxes or, on the other hand, by judging the overall effect of the activity conducted by the foreign company. The French *Conseil d'Etat* had advocated the need to limit the analysis to the object of the activity only, while the previous project of CFC reform focused on the effect of the operation.

The United Kingdom CFC regime provides for chargeable profits of the foreign entities to be apportioned to those with an interest in the controlled foreign company and for a UK-resident company holding, with connected persons and associates, at least a 25% interest in the foreign company will be assessed on its apportioned share of the profits. The provisions apply if the controlled foreign company is under UK control (40% being the relevant threshold) and is resident in a "low-tax country"; for the purposes of UK CFC legislation, a country is considered as being "low-tax" if the tax imposed therein is lower than three-quarters of the tax that would be levied in the United Kingdom[745].

The British CFC regime incurred extensive reform after the Court's judgement on the *Cadbury Schweppes* case[746], after the Luxembourg Judges found that an EU subsidiary of a UK company should not be subjected to the UK CFC provisions, even if the establishment of the foreign company was put in place explicitly for the purposes of benefiting from favourable tax regimes, unless the foreign company has no real substance, constituting a "*wholly artificial arrangement*". The Court, thus, ruled that the UK CFC regime in place at the time was incompatible with European Union law insofar as it applies to situations other than "*wholly artificial arrangements*", but that it is for the domestic court to analyse the legislation as a whole in order to define whether or not the scope of application of the regime was properly limited.

After the judgement, new legislation was, therefore, introduced, with effect from December 2006, applying to subsidiaries of UK companies that are subject to an apportionment under CFC rules and have a business establishment in a Member State of the European Union[747].

The regime previously encompassed, *inter alia*, provisions aimed at ensuring that the charge will only arise where a controlled foreign company is used to the purpose of avoiding taxes, excluding from the scope of application of the regime all controlled foreign companies pursuing an acceptable distribution policy[748] or conducting exempt activities[749]. Both of these exemptions have been repealed in 2009.

[745] There used to be an exemption for controlled foreign companies quoted on foreign stock exchanges, but it has been removed with effect from December 2006.

[746] On the point, see Chapter II of the present research, paragraph 7. It should be noted that, in the United Kingdom, three references to the Court of Justice of the European Union were made with regard to the compatibility of the UK CFC regime with European Union law, i.e. the *Cadbury-Schweppes* case, the *CFC Group Litigation order* case (Case C-201/05) and the *Vodafone 2 v. HMRC* case (2005).

[747] Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 1140.

[748] More in detail, in order to qualify for the exclusion from the scope of the CFC regime, trading companies must distribute 90% of their taxable profits less capital gains and foreign tax.

[749] The rules restrict the use of intra-group service companies and limit the cases where a foreign holding company qualifies for the exemption from the regime at issue. On the point, Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 1139.

The most recent reform of UK CFC provisions, which are now enshrined in Part 9A of TIOPA 2010, introduced by Finance Act 2012 and in place since 1 January 2013, has constituted an essential part of a larger strategy, with the clear political purpose of attracting foreign business and especially holding companies through measures making steps towards a more territorial tax model, with the United Kingdom not levying taxes on the worldwide income of a corporate group having its main holding in UK territory, but concentrating the tax levy on the profits deriving from activities taking place in that territory, with the prevalence of a source-based approach[750].

The new UK CFC regime conforms to this "territorial" tendency[751].

Finance Act 2012 has introduced the concept of a "CFC charge gateway" through which profits of a controlled foreign company must pass in order to be considered as chargeable profits. Depending on certain criteria, profits are considered for the purposes of said gateway if they are attributable to activities conducted in the United Kingdom, if they are finance profits and if they derive from captive insurance business. An exemption has also been introduced for companies that are newly under UK control, for companies conducting business in excluded territories and for companies with low profits. An exemption is also provided for finance profits arising from intra-group loans[752].

First of all, it provides for an exemption for "foreign-to-foreign" infra-group operations, which are not related to the UK tax base, and also for an exemption concerning financial companies, which is linked to the debt-equity ratio: a CFC charge is levied when the balance between debt and equity in the financing of the foreign company significantly shifts towards equity.

Special attention is paid to income deriving from the employment of intellectual property: the regime provides for a number of exemptions with regards to all cases which are characterised by a feeble connection with the territory of the United Kingdom and to all cases where the presence of a non-significant territorial connection combines with reduced dimensions of the company, with a sort of "*de minimis*" exemption of IP income. The CFC regime is, however, applied when the relevant underlying intellectual property has been created in the United Kingdom and then transferred to a low-tax country or is effectively managed in the United Kingdom, even though being detained by a subject located in a foreign country or, finally, is the result of an investment made abroad, but financed through UK funds. These are all cases characterised by a strong

[750] Avi-Yonah, R.S., *The structure of international taxation: a proposal for simplification*, cited above, 15.
[751] Cipollina, S., *Profili evolutivi della CFC legislation: dalle origini all'economia digitale*, cited above, 364.
[752] Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 1140.

territorial connection between the intellectual property and the United Kingdom, thus justifying the application of the CFC regime.

What has been highlighted above constitutes only the peculiar traits of the United Kingdom's CFC regime, constituting an example of how the United Kingdom has implemented a "territorial CFC regime". Which sounds like an oxymoron, given what has been said above on CFC regimes constituting, by nature, an extraterritorial exercise of taxing powers on the part of the states. However, the United Kingdom, with specific carve-outs and exemptions has tried to implement a system by virtue of which the application of the CFC regime is, to a certain extent, limited to the income that can be considered as somehow connected to the territory of the United Kingdom. This is one of the reasons why it does appear there not to be any problem of compatibility of the UK CFC regime with the standards enshrined in Articles 7 and 8 of the new Anti-Tax Avoidance Directive.

6. A comparative perspective on exit taxation.

As already highlighted in the previous chapters of the research, exit taxation has always constituted a natural test bench for the compatibility of Member States' national tax regimes with European Union law. In the context of the European Union, exit tax measure, in fact, by their nature, can only apply at the moment when an EU citizen exercises his/her/its right of cross-border movement, thus impacting directly on the possibility to exercise freedom of movement of persons and/or workers or freedom of establishment and, in any case, freedom of movement of capital. Exit tax measures operate at the moment where the taxpayer changes his/her/its status, becoming a non-resident when he/she/it was previously a resident.

As far as corporate taxation is concerned, the topic of exit taxation is inevitably intertwined with the perspective of the Member States' commercial law, as far as corporate taxation is concerned.

With regard to the aspect concerning the maintaining of the status of "national company" or similar, in fact, countries can generally be divided into two main categories: those countries, such as Italy and the United Kingdom, applying the so-called "incorporation theory", according to which a company is subject to the laws of the state where it was constituted, and those countries, on the other hand, applying the so-called "real seat theory", according to which the law applicable to companies is the law of the

state where the company's administration is located on a factual basis[753]. For countries belonging to the second category, the transfer of the company's administrative seat abroad implies the loss of its effective nexus with the territory of the State, which also implies the loss of its fiscal residence (and the consequent exit taxation).

On the point, as highlighted by the Court of Justice in the *Daily Mail* and *Cartesio* judgements[754], Member States are free to identify the connecting criteria on the ground of which a company may be considered as incorporated pursuant to their national law and also the criteria which are necessary in order to a company to maintain that status. The only limit posed by the Luxembourg Judges to the Member State of departure (i.e. the Member State of incorporation of the company) is the general prohibition to enact measures aimed at preventing a company's transfer abroad with the switch to another applicable law, i.e. with the conversion of that company into a corporate form which is compatible and subject to the laws of the Member State of destination, with a consequent restriction imposed on the company's freedom of establishment.

As also noted in the previous chapter of the present research, it cannot be doubted that there has been a substantial change of perspective with regards exit taxation in recent times: national tax systems on exit taxation serve (or used to serve) national fiscal and financial interests; in a context such as the European Union, deprived of any direct actual taxing power, a legislation on exit taxation can only be justified as a limit to the exercise of the Member States' taxing powers or with a view to the prevention of abusive behaviours on the part of taxpayers[755].

The implementation of European Union law in the field of exit taxation has led to a dissociation between taxing powers and their exercise, with the first being, in principle, legitimate and compatible with EU law, and the second being compatible under certain circumstances. From this perspective, it is essential to turn to the analysis of domestic regimes in order to verify whether or not the somehow limited territorial exercise of taxing powers on the part of the Member States may be effectively justified against the unity of the Internal Market.

According to the Court's jurisprudence, for instance, the source Member State cannot immediately exercise its taxing power on unrealised capital gains at the moment of the transfer of residence to another tax jurisdiction being part of the European Union, postponing the collection of the taxes to a later moment: this was the compromise

[753] Sallustio, C., *Il trasferimento della sede e della residenza fiscale all'estero e dall'estero in Italia. Profili sistematici*, in Rivista di Diritto Tributario, 2014, 3, 353.
[754] Respectively, Court of Justice of the European Union, 27 September 1988, C-81/87, *Daily Mail* and Court of Justice of the European Union, 16 December 2008, C-210/06, *Cartesio*.
[755] Di Pietro, A., *Past and perspectives of exit tax*, cited above.

reached by the Luxembourg Judges in order to guarantee the effectiveness of the primacy of European Union law and of the protection of the Internal Market, though, on the other hand, without sacrificing the interests of the source Member State.

Therefore, through its rulings, the Court of Justice has clarified which elements cannot be part of an exit taxation measure, at least with regard to those measures applicable to intra-EU transfers, thus developing an "EU exit tax negative model" for all Member States to adhere to. According to the Court, for instance, Member States may not charge immediate taxation at the moment of the intra-EU transfer, but taxes must be levied at the moment of the actual realisation of the capital gain, also to the purpose of duly taking into account losses possibly deriving from the disposal of the concerned asset; furthermore, Member States may not impose excessively burdensome guarantees on migrating taxpayers, given the possibility to resort to the mutual cooperation and exchange of information procedures provided by EU law[756].

Notwithstanding the establishment of these judge-made criteria, Member States' law on the point of exit taxation has for a long time been quite different from one country to another, leading to uncertainties for taxpayers and for tax authorities. With the enactment of the Anti-Tax Avoidance Directive, as it has been shown in the previous chapter of the present research[757], the EU legislature has tried to reach a harmonisation of exit taxation.

6.1. The Italian experience.

Under Italian tax law, the transfer of an Italian company's fiscal residence and the cross-border transfer of assets belonging to a permanent establishment located in Italy of a non-resident company to another country, including a Member State of the European Union, both trigger exit taxation.

Before continuing with the analysis of the provision, it is relevant to highlight at the outset that, according to Italian law, a migrating company can maintain its legal personality, without the need to liquidate and then re-incorporate into a new corporate form in the host country[758], which would argue in favour of the compatibility of Italian law with the "*Cartesio* doctrine". Therefore, a company can transfer its registered office in a foreign territory provided that the legal requirements set out by Italian law and the legal requirements set out by the host country are met. Italian law also allows companies

[756] Di Pietro, A., *Past and perspectives of exit tax*, cited above; Carinci, A., *Il diritto comunitario alla prova delle exit taxes, tra limiti, prospettive e contraddizioni*, cited above.
[757] See Chapter III, at paragraph 5.
[758] See Article 25, paragraph 3, of Italian Law n. 218 of 31 May 1995.

to transfer their administrative office abroad while maintaining their legal personality: in this case, the problem concerning which law applies to the company which has transferred its administrative office is solved by the conflict of law provisions of the relevant jurisdictions.

It should also be noted that, according to the majority of Italian legal scholarship, if a resident company maintains at least one of the connecting criteria with the territory of the State, as established by Article 73 of Presidential Decree n. 917/1986[759], said company will continue to be considered as fiscally resident in Italy for the purposes of Italian tax law and fiscally resident in the country of destination only for the purposes of the applicable double taxation convention. Which prevents the application of exit taxation measures, that are applicable only in case of loss of fiscal residence on the part of a former resident[760].

That being said, according to Italian tax law, all taxpayers are subjected to specific forms of tax provisions in case they transfer their residence to a foreign country, irrespective of them being subject to Corporate Income Tax ("*IRES*") or Personal Income Tax ("*IRPEF*"), even though the applicable provisions differ depending on the characteristic of the migrating taxpayer, i.e. whether he/she/it is a company or an individual conducting business activities in Italy or an individual not conducting any business activity.

The transfer of residence abroad by a company or enterprise is expressly considered as an event giving rise to a capital gain for the purposes of Article 166 of Presidential Decree n. 917/1986. Furthermore, the transfer or residence abroad is specifically regulated by anti-avoidance and anti-evasion provisions, with a presumption of residence in Italy for companies residing abroad but maintaining a substantial presence in the Italian territory[761].

Italian tax law does not impose an "authentic" exit tax in case of transfer of residence by individuals not conducting business activities, which means that the specific problems examined by the Court of Justice in cases such as *De Lasteyrie du Saillant* do not appear to exist with regard to the Italian legal order[762]. It should, however, be highlighted that where a foreign individual transfers his/her residence to Italy and subsequently disposes of assets that he/she had held in the period of time before

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[759] See above, at paragraph 2.

[760] Sallustio, C., *Il trasferimento della sede e della residenza fiscale all'estero e dall'estero in Italia. Profili sistematici*, cited above, 357.

[761] Tassani, T., *Transfer of residence and exit taxation in EU law: the Italian approach*, cited above.

[762] Tassani, T., *Transfer of residence and exit taxation in EU law: the Italian approach*, cited above; Lupi, R., *Coerenza del sistema fiscale tra dividendi esteri ed exit tax*, in Dialoghi di Diritto Tributario, 2004, 3, 1365; De Pietro, C., *Compatibilità comunitaria di exit tax su partecipazioni rilevanti*, in Rassegna Tributaria, 2006, 4, 1377.

transferring his/her residence to Italy, the capital gain is taxed in its entirety by the Italian State.

Nonetheless, the current version of Article 166 of Presidential Decree n. 917/1986[763] applies to all "*subjects exercising a commercial enterprise*" only, that is to say individuals, non-commercial entities, partnerships, corporations and commercial entities, while other persons not exercising a trade fall within the scope of application of paragraph 2-*bis* of Article 2 of Presidential Decree n. 917/1986, pursuant to which, as we have already seen, a resident individual who transfers his/her residence to a tax haven will nonetheless be treated as residing in Italy for fiscal purposes unless he/she is able to prove that the transfer of residence really coincides with the substantive nature of his/her abode: the result is, therefore, an inversion of the regular burden of proof.

The difference in treatment between individuals not conducting business activities and subjects exercising a commercial enterprise is justified by the fact that it is common for Italian corporate tax law to allow either an exemption or a deferral of taxation (carry-forward) on unrealised capital gains based on the fact that they are going to be taxed at a later time and, in any case, when the business is wound up. However, if before that event, circumstances occur which give rise to the transfer abroad of the wealth that has not been taxed yet, the State risks not to recuperate the deferred taxation on capital gains which was "suspended" until realisation[764]. This phenomenon obviously does not occur with regards to individuals that do not conduct any business activity, since they are generally not granted deferral advantages such as those mentioned above in the field of business taxation.

Furthermore, the "loss of a resident", for a country such as Italy, following a traditional "worldwide" approach to taxation of residents and taxing non-residents only on their income produced in Italian territory, implies a significant change of perspective: when a resident person becomes a non-resident, taxation shifts from that person's overall income, wherever accrued, to a more "territorial" approach, with taxes being levied exclusively on income having its source within Italian territory, and with the consequence of capital gains not yet accrued and other items of income possibly "suspended" for tax purposes escaping from the tax net of the Italian Republic[765]. The main issue, therefore, is centred, as we will see, on the relevant connecting criterion applicable to the circumstances and whether or not the "personal" connection based on

[763] As modified by D.L. n. 1/2012 of 24 January 2012, ultimately approved by l. n. 27/2012 of 24 March 2012, following an infringement procedure initiated by the Commission against Italy (n. 2010/4141).

[764] Fantozzi, A., Paparella, F., *Lezioni di diritto tributario dell'impresa*, cited above, 232; Pizzoni, B.E., *La compatibilità delle exit tax con il diritto comunitario*, in Rivista di Diritto Tributario, 2004, 3, 51.

[765] Fantozzi, A., Paparella, F., *Lezioni di diritto tributario dell'impresa*, cited above, 233.

residence is replaced by an "objective" connection (i.e. the presence of a permanent establishment).

Pursuant to Article 166, both the transfer of an Italian corporation's residence to a foreign territory and the cross-border transfer of assets allocated to an Italian permanent establishment of a non-resident company to another country generally trigger the immediate application of exit tax measures, with levies being imposed on the unrealised capital gains, which are calculated with reference to the difference between the normal value of the assets and their fiscally recognised cost. Which does not happen in case of a purely domestic transfer. Nonetheless, Article 166 provides for the possibility to ask for a deferral of the payment of the exit tax due in that case.

However, such exit taxation measures do not apply in case the assets previously constituting part of the Italian company that has been transferred abroad remain somehow connected to a permanent establishment located in Italian territory: in this case, in fact, the transfer of residence does not ultimately imply any subtraction of tax base to the detriment of the Italian public coffers, since the connection to the Italian State is not lost[766]. This is, in fact, a case where the connecting criterion based on residence is replaced by a source-based connecting criterion, i.e. the presence of a permanent establishment, allowing the Italian State to extend its taxing powers, to a certain extent, to a "newly foreign" subject as well.

The provision links the taxation of unrealised gains to the continuity of the application of the Italian fiscal regime to the business, at least with regard to the business income attributable to the permanent establishment that remains located in Italian territory even after the transfer abroad of the home office. For the same reason, Italian tax law provides that, in case of a transfer abroad of a "formerly Italian" company, the unrealised gains related to the permanent establishment held by that company are deemed as realised at the moment of the transfer, since after said transfer, there is no way to provide for any continuity of the connecting criterion[767].

As an effect of the above-mentioned regime, the unrealised capital gains are deemed as realised, after the transfer, with taxation being consequently triggered, if the assets which have become part of the permanent establishment located in Italian territory are subsequently disposed of. The capital gain is determined on the basis of the fair market value of the assets at the time of transfer.

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[766] Fantozzi, A., Paparella, F., *Lezioni di diritto tributario dell'impresa*, cited above, 233; Melis, G., *Trasferimento della residenza all'estero ed elusione fiscale*, cited above, 516.
[767] Tassani, T., *Transfer of residence and exit taxation in EU law: the Italian approach*, cited above.

Article 166, paragraph 2-*quater*, establishes the possibility to apply for a deferred payment of the exit tax due with respect to transfers of tax residence to another EU Member State or a country adhering to the EEA or a country ensuring an adequate level of exchange of information with Italy[768]. More specifically, taxpayers may ask for the suspension of the payment of the taxes due on the capital gains that have been deemed as realised at the moment of the transfer[769] until the time of actual realisation of the capital gains connected with the relevant assets transferred abroad. It is also possible to opt for the payment by way of instalments.

Regardless of whether the taxpayer has applied for deferred taxation or the payment in instalments, the exit tax relating to a transferred asset is immediately due when realisation occurs in the host Member State[770].

It has been debated in Italian scholarship whether the provisions of Article 166 of Presidential Decree 917/1986 constitute new rules having anti-avoidance nature or rules that can be traced back to a more systematic view of the Italian tax system and, in particular, with the fiscal treatment of capital gains[771]. Part of legal scholarship has argued that the current provisions of Article 166 of Presidential Decree 917/1986 seems to have put in place a significant change of perspective, stepping away from the traditional nature of anti-avoidance rules and paying a higher degree of attention to the systematic coherence of the tax system, thus taxing latent capital gains when the assets finally exit the enterprise[772].

This is one of the reasons who has led many scholars to exclude the possibility to consider the Italian exit taxation regime as contrary to European Union law, since the rule does not constitute a derogation from the general principles regulating the Italian tax system, but rather an application of general tax principles in cases where the company's assets are used for purposes other than the main business of the company or exit the scope of application of the Italian business tax regime[773].

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[768] On the point, see Ministerial Decree of 2 July 2014 implementing the optional deferral regime.

[769] Said value is generally calculated as the difference between the normal market value and the fiscal value of the transferred assets.

[770] Potgens, F.P.G., van Os, P., Duran, P.H., et al., *The compatibility of exit tax legislation applicable to corporate taxpayers in France, Germany, Italy, the Netherlands, Portugal, Spain and the United Kingdom with the EU freedom of establishment*, cited above, 58

[771] Sallustio, C., *Il trasferimento della sede e della residenza fiscale all'estero e dall'estero in Italia. Profili sistematici*, cited above, 358; Melis, G., *Trasferimento della residenza all'estero ed elusione fiscale*, cited above, 516.

[772] Fantozzi, A., Paparella, F., *Lezioni di diritto tributario dell'impresa*, cited above, 236; Melis, G., *Trasferimento della residenza all'estero ed elusione fiscale*, cited above, 516; Tassani, T., *Transfer of residence and exit taxation in EU law: the Italian approach*, cited above. This position seems to solve the age-old debate, in the context of Italian legal scholarship, on the (systematic or purely anti-elusive) nature of exit taxation provisions.

[773] Tassani, T., *Transfer of residence and exit taxation in EU law: the Italian approach*, cited above; Ficari, V., *Trasferimento della sede all'estero, continuità della destinazione imprenditoriale e contrarietà al Trattato CE dell'exit tax sulle plusvalenze latenti*, in Rassegna Tributaria, 2004, 6, 2146.

Consequently, it would not be possible to attribute to the provisions at issue any discriminatory purpose with regards to those subjects transferring their residence in a foreign country or, in any case, any discriminatory or restrictive measure would have to be considered as justified by the need to ensure the coherence of the tax system. In other words, the Italian exit taxation regime seems to be in line with an allocation of taxing powers amongst Member States based on territorial criteria, which leads to concluding in favour of the compatibility of the measure with EU law, since, in application of the "*Futura* doctrine"[774], taxation reflecting the principle of territoriality can be considered as balanced and proportioned[775].

6.2. The French experience.

Current French tax law entails a provision pursuant to which, briefly said, a corporate taxpayer relocating its place of effective management, statutory seat or permanent establishment located in France to another country, including another Member State, with the operation thus resulting in a transfer of assets, would trigger the application of exit taxation measures.

France has introduced measures on exit taxation for the first time in 1998, providing for the taxation of unrealised capital gains accrued on a French-resident taxpayer at the moment of his/her/its emigration to another country. In 2004, the exit tax measure at issue was considered as incompatible with European Union law and with the freedom of establishment by the Court of Justice with the *Lasteyrie du Saillant* judgement[776], which led to a series of subsequent reforms on the point, until the last modification to the rule, enacted in 2012[777].

Over the years, the French exit taxation regime has evolved through the interpretation given and the limits provided by judicial intervention. For example, on the application of the above-mentioned provisions with specific regard to emigration to a non-EU Member State, reference should also be made to a judgement rendered by the French *Conseil d'Etat* in 2013[778]. The case dealt with the application of exit taxation provisions in relation to the rules enshrined in the double taxation convention between France and Switzerland. Under article 15 of said convention, in fact, the right to tax

[774] See Chapter II of the present research, paragraph 4.
[775] Tassani, T., *Transfer of residence and exit taxation in EU law: the Italian approach*, cited above.
[776] On the point, see Marchessou, P., *Exit tax under French law in the light of the case De Lasteyrie du Saillant*, in European Tax Studies, 2009, 1, 1.
[777] Gouthière, B., *New exit tax for individuals*, in European Taxation, 2012, 1, 42.
[778] *Conseil d'Etat*, 29 April 2013, n. 357576, *Mr. Picart*.

capital gains on shares and securities is attributed to the state of residence of the taxpayers. On the point, the *Conseil d'Etat* considered that the French exit tax was due before the completion of the transfer of residence and not after said transfer, i.e. in a moment when the taxpayer was still a French resident for tax purposes, thus ruling that the exit tax measure at hand was not contrary to the provisions of the double taxation convention between France and Switzerland.

In 2012, following the *National Grid Indus* and *Commission v. Portugal* decisions of the Court of Justice, the French Government has once again modified the fiscal regime connected to the transfer of assets, explicitly making reference to the need to establish a balanced allocation of taxing powers amongst Member States and also clarifying that the legislation is supposed to act as a "*deterrent aiming at depriving the tax refugee of the benefits of his expatriation by taxing him in the same manner as if he had never left France*"[779].

As far as individuals are concerned, after years during which France has never imposed any sort of exit taxation on individuals, Article 167-*bis* CGI currently establishes that individuals transferring their fiscal residence outside French territory are taxable, at the time of the transfer, on any unrealised increase in value of shares, earn-out receivables and rolled-over capital gains under certain conditions. With regards to capital gains (especially on shares, constituting the main target of the legislation at issue), exit taxation applies if the concerned individual has been domiciled in France for at least six years during the ten years preceding the emigration[780]. Tax is charged on unrealised capital gains on shares or rights held directly or indirectly by the migrating individual if certain thresholds are met[781] and the taxable gain is computed making reference to the difference between the fair market value of the individuals' chares at the time of the transfer and their cost base.

Individuals may benefit from a suspension of payment under certain conditions depending on their country of destination. If they move to another EU Member State, the individuals concerned automatically benefits from an automatic suspension of payment of the exit tax due without any condition, without having to provide guarantees and without the need to require prior authorisation to the tax authority, which seems to advocate in favour of the compatibility of the measures at issue with European Union law and with the Court of Justice's jurisprudence on exit taxation[782]. Even more so if we

[779] Amending Finance Law for 2012, 29 December 2012, n. 2012-1510.
[780] This condition is applicable to earn-out receivables as well, but not to rolled-over capital gains.
[781] The members of the taxable unit must own either a direct or indirect shareholding of at least 1% in the profits of a company or in the same companies, a direct or indirect shareholding the value of which exceeds 1.3 million Euros at the time of the transfer of residence. On the point, see Gouthière, B., *New exit tax for individuals*, in cited above, 42.
[782] Gouthière, B., *New exit tax for individuals*, cited above, 44.

consider that the tax base may be corrected after the transfer of residence in order to take into account the actual gain realised by the taxpayer, so as to prevent the individual from being taxed on a non-existing gain, and that a number of provisions have been introduced to ensure that the migrating taxpayer is not subject to more burdensome taxation than if he/she had not exercised his/her right to free movement within the Internal Market.

In case of transfer of residence to a country which is not a EU Member State, the individual taxpayer may also benefit from a suspension of payment of the exit tax due at the moment of his/her transfer but he/she must provide appropriate guarantees and designate a fiscal representative in France, with the necessary authorisation of the French tax authority. Which has led some commentators to wonder about the compatibility of such a measure with the Treaty freedom of movement of capital, i.e. the only fundamental freedom applying to third-country scenarios as well.

The 2012 reform concerned French corporate exit taxation as well.

The previous version of Article 221-2 CGI, in fact, called for all transfers of assets accompanied by a transfer of seat or for all transfers of permanent establishments to trigger an immediate French taxation to latent capital gains, with no possibility for any payment by way of instalments.

Nowadays, the current version of Article 221-2 CGI establishes the fiscal consequences of a company's transfer of seat or permanent establishment, distinguishing between, on one hand, the case in which said seat or permanent establishment is transferred to a country that is not a Member State of the European Union and, on the other hand, the case in which said seat or permanent establishment is transferred to another Member State[783].

It should be noted, first of all, that, according to French law, in absence of any specific rule on the point, the transfer of a company to a foreign territory does not generally entail the necessary loss of its legal personality from the perspective of the French legal order[784] and a French company is not prevented from being converted into a company incorporated under the law of another Member State, depending on the treatment applicable in the host Member State. Thus, French (company and tax) law

[783] For further details on the more practical aspects of the topic, see the French Tax Authorities' guidelines BOI-IS-CESS-30-20130903.

[784] French company law adheres, in general terms, to the "incorporation principle" for the purposes of determining the law applicable to a certain corporation. Article 1837 of the French Civil Code and Article L. 210-3 of the French Commercial Code provide that all companies whose seat is located in French territory are subject to French law, with that place generally coinciding with the place of incorporation of those companies. However, pursuant to the same articles mentioned above, third parties may claim that a certain company's statutory seat is fictitious or does not coincide with the place of effective management of that company: in this case, the company would be considered as located at the place of its real seat.

appears to be in line with the Court of Justice's "*Cartesio* doctrine"[785] from this perspective[786].

Therefore, in case of a transfer of seat (with no distinction being traced between the transfer of a company's statutory seat or the transfer of the place of effective management) or of permanent establishment to another Member State that is not accompanied by a simultaneous transfer of (either material or immaterial) assets, the transaction is considered as fiscally neutral with regard to corporate income taxation: therefore, there is no restriction for cross-border transfers if compared to purely domestic ones[787].

However, if a French company transfers its place of effective management, its statutory seat or one of its permanent establishments together with qualifying fixed assets (e.g. intangibles, property, plants, equipment, equity and debt securities, certain financial assets, etc.[788]) to another country, such a transfer triggers the taxation of unrealised capital gains, that are deemed realised at the moment of the transaction and the taxation of any deferred capital gains. On the other hand, however, a French corporation transferring its seat within French territory would not be taxed on any of its unrealised gains at the moment of the transfer.

Like Italy, France, therefore, applies the fiction that the relevant assets are disposed of at their fair market value at the date of the transfer and determines the amount of exit tax due by the company with regard to that value. Therefore, any capital gains or capital losses that may occur subsequently concerning the transferred assets will have no impact on the amount of exit tax due, which is definitively determined at the date of the transfer[789].

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[785] According to the Court of Justice of the European Union, when the host Member State allows the possibility of the conversion of a company incorporated under its law, freedom of establishment requires that Member State to allow for the conversion of a company incorporate under the law of another Member State into a company that is governed by its law under the same conditions as a "purely domestic" conversion and the Member State of origin to allow for the "outbound conversion" of a company incorporated under its law while maintaining its legal personality: these principles have been voiced by the Court in its *Cartesio* decision (Court of Justice of the European Union, 16 December 2008, C-210/06), as well as, more recently, in its *Vale* judgement (Court of Justice of the European Union, 12 July 2012, C-378/10). On this point, see also the second chapter of the research, at paragraph 9.

[786] Potgens, F.P.G., van Os, P., Durand, P.H., et al., *The compatibility of exit tax legislation applicable to corporate taxpayers in France, Germany, Italy, the Netherlands, Portugal, Spain and the United Kingdom with the EU freedom of establishment*, cited above, 45.

[787] Potgens, F.P.G., van Os, P., Duran, P.H., et al., *The compatibility of exit tax legislation applicable to corporate taxpayers in France, Germany, Italy, the Netherlands, Portugal, Spain and the United Kingdom with the EU freedom of establishment*, cited above, 56.

[788] See the French Tax Authorities guidelines BOI-IS-CESS-30-20130903 n. 50.

[789] Potgens, F.P.G., van Os, P., Duran, P.H., et al., *The compatibility of exit tax legislation applicable to corporate taxpayers in France, Germany, Italy, the Netherlands, Portugal, Spain and the United Kingdom with the EU freedom of establishment*, cited above, 169.

Pursuant to Article 221-2 of the French Tax Code, in that case, the taxpayer may choose between paying the tax immediately at the moment of the transfer and paying the taxable amount through five annual instalments.

Furthermore, if a company transfers all of the assets that it owns at the moment of the transfer abroad, another tax consequence follows: since the company will no longer be taxed in France, the transfer will entail the consequences of the termination of a company, that is to say immediate tax being levied on all of that company's profits that have not been taxed yet at the moment of the transfer.

Moreover, pursuant to Article 38 of the French Tax Code, in case of a separate transfer of assets to a foreign permanent establishment, not connected to any transfer of seat or permanent establishment, immediate taxation of capital gains would be triggered, while the same would not apply in case of a purely domestic transfer of assets. The corporate taxpayer has the option to pay the exit charge either in full or, upon request, in five-year instalments. In that second option, the exit tax would become payable immediately in the event of the sale of the assets, the dissolution of the company, the failure to comply with the five-year payment schedule or the transfer of the assets to a country other than a EU Member State.

6.3. The UK experience.

UK exit taxation has always been designed as capital gains taxation concerning both individuals and corporations, even though this trait has been, in recent times, modified, thus turning exit taxation measure into charges concerning exclusively companies and targeting disposals of assets by a UK corporate taxpayer to an affiliate residing in another country (if the assets are not attributable to a UK permanent establishment of that affiliate), the transfer of an asset attributable to a UK permanent establishment to a person located in another country and the transfer of the place of effective management of a UK company to another country[790].

A "return tax" had been established for those individuals that, after having left the United Kingdom, came back to the UK after a certain period of non-residency, with a charge payable on return into the United Kingdom, but said charge has now been repealed, as part of the general policy purpose of attracting holding companies and high-wealth individuals to the UK[791].

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[790] Marrani, D., *Contribution to the study of 'exit tax' in the UK*, in European Tax Studies, 2009, 1.

[791] More in detail, Finance Act 1998 introduced a section 10A to the Taxation of Chargeable Capital Act (TCGA) 1992, imposing taxation on gains accruing from sales of assets, on the part of individuals who had been resident

However, a sort of "exit charge" - even though it is not an exit taxation measure in the strict sense of the concept of what has been called "exit taxation" - is still in place as regards individual taxpayers as well.

UK legislation concerning the tax consequences of transfers of assets abroad by individuals is, in fact, contained in Chapter 2 of the Income Tax Act 2007. The provisions at issue have a declared anti-avoidance purpose: more in detail, Income Tax Act 2007, Section 720(1) reads as follows: "*the charge under this section applies for the purpose of preventing the avoiding of liability to income tax by individuals who are ordinarily UK resident by means of relevant transfers*"[792].

Therefore, under ITA 2007, Section 720, if an individual transfers assets and, as a result of that transfer, income becomes payable to any person, including a corporation[793], resident or domiciled outside the United Kingdom and the transferor either maintains the power to enjoy that income or receives a capital sum, the income of the non-resident person is taxed as that of the transferor[794]. Nonetheless, an individual is not chargeable to income tax under the above-mentioned rules in respect of any income if he/she is domiciled outside the United Kingdom and subject to the condition that, if the income had in fact been that individual's income, because of him/her being domiciled abroad, that income would not have been chargeable to income tax[795].

A tax charge will, thus, only apply if an individual ordinarily resident in the United Kingdom has the power to enjoy the income of a person resident or domiciled outside the United Kingdom. This "power of enjoyment" must be held by the transferor or his/her spouse. Pursuant to ITA 2007, Section 722, "*in determining whether an individual has power to enjoy income […] regard must be had to the substantial result and effect of all the relevant transactions*" and "*in making that determination all benefits which may at any time accrue to the individual as a result of the transfer and any associated operations must be taken into account, irrespective of the nature or form of the benefits or whether the individual has legal or equitable rights in respect of the benefits*". The charge to tax will also apply where, in

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of the United Kingdom for any part of the previous four years out of the seven tax years immediately preceding the year of departure and who had become non-residents (and not ordinary resident) for a period of less than five tax years and owned assets before leaving the United Kingdom. Section 10A TCGA 1992 was modified after the Court of Justice of the European Union's judgement on the *De Lasteyrie du Saillant* case, taking into account the possibility of the legislation being contrary to EU law, and then repealed. On the point, see Marrani, D., *Contribution to the study of 'exit tax' in the UK*, cited above.

[792] Pursuant to Income Tax Act (ITA) 2007, Section 716, "*a transfer is a relevant transfer for the purposes of this Chapter if a) it is a transfer of assets, and b) as a result of i) the transfer, ii) one or more associated operations or iii) the transfer and one or more associated operations, income becomes payable to a person abroad*".

[793] For the purposes of the application of the rules at issue, pursuant to Income Tax Act (ITA) 2007, Section 718, a company incorporated outside the United Kingdom is always considered as a non-resident even if it is, in fact, a UK-resident.

[794] Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 488.

[795] Income Tax Act (ITA) 2007, Section 726.

connection with a transfer of assets abroad, the transferor of such assets or his/her spouse receives or is entitled to receive a capital sum[796], whether before or after the transfer.

An individual has a right to avoid the application of the above-mentioned provisions if either it would be unreasonable to conclude, from a factual and objective analysis of the circumstances, that tax avoidance was the purpose, or one of the purposes, of the assets' transfer abroad, or that the relevant transactions were genuine commercial transactions and that it would not be reasonable to conclude that any of the relevant transactions were more than incidentally designed for the purpose of avoiding taxes[797]. The relevant burden of proof is put on the taxpayer.

British jurisprudence has accepted that, in order for a taxpayer to be exempted from the application of the above-mentioned rules, it can be considered as sufficient to demonstrate that tax avoidance was not the only, or principal, aim of the transactions at issue. More specifically, in the *IRC v. Willoughby* judgement[798], the House of Lords accepted that, if the overall objective of the transaction was not tax avoidance, the "motive defence" could apply even if the purpose was achieved in a tax-efficient manner.

The measure described above, however, does not constitute a "proper exit tax provision", but rather a measure falling within the category of anti-avoidance provisions, with no systematic purpose whatsoever. A "proper exit taxation measure" is, on the other hand, provided by UK tax provisions with exclusive regard to corporate entities, being enshrined and regulated in Section 185 of the Taxation of Chargeable Gains Act 1992[799].

As highlighted above, a company incorporated in the United Kingdom is generally deemed to be resident in the United Kingdom for tax purposes regardless of its place of effective management, the United Kingdom giving prevalence to a strict application of the so-called "incorporation principle".

A company incorporated pursuant to UK law cannot transfer its registered office to a territory located outside the United Kingdom: a UK company can move its fiscal

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[796] A "capital sum" for the purposes of the legislation at issue is defined as a sum paid or payable by way of loan or repayment of a loan or any sum, not constituting income, which is paid or payable otherwise than for full consideration in money or money's worth (ITA 2007, Section 728).

[797] Income Tax Act (ITA) 2007, Section 737.

[798] House of Lords, 16 July 1997, *Inland Revenue Commissioner v. Willoughby* ("*It would be absurd […] to describe as tax avoidance the acceptance of an offer of freedom from tax which Parliament has deliberately made. Tax avoidance within the meaning of s. 741 is a course of action designed to conflict with or defeat the evident intention of Parliament*").

[799] The measure was introduced for the first time with Finance Act 1998. Originally the regulation of the measure was complemented by Sections 186 and 188, which were both repealed, which means that Section 185 is currently the "key provision" with regard to British exit taxation.

residence offshore in fairly limited circumstances and such migration, where and insofar as it is allowed, has no effect on the remaining legal personality of the company or its status under UK company law: in other terms, a UK-incorporated company cannot lose its UK residence.

Therefore, there is no procedure, under UK company law, through which a UK company can be converted into a company governed by another country's law, even in case the "conversion" would be made with another subject located in a EU Member State. However, as the United Kingdom does not provide for a procedure for a UK incorporated company to be converted into another UK incorporated company, the fact that this possibility is denied in cross-border circumstances as well might not constitute a breach of the principle of non-discrimination, while it remains to be seen whether or not it might constitute an undue restriction of the Treaty freedom of establishment, even though the regime at issue would seem to be compatible with the "*Cartesio* doctrine".

On the other hand, the transfer of an asset from a UK company to another European Union Member State (including a transfer of a permanent establishment of that same company in foreign territory) is not a taxable event *per se* for the purposes of UK tax. Therefore, the transfer of an asset by a UK company to another Member State potentially triggers UK taxation only if accompanied by a "disposal" of the asset for the purposes of UK capital gains taxes, such as a sale. Therefore, the transfer of an asset without a simultaneous change of its ownership status from the United Kingdom to another Member State does not trigger the levy of any UK tax if the transferor is a company subject to UK corporate taxation. By contrast, tax may be charged if a non-resident company established in another Member State with a UK permanent establishment transfers an asset located in the UK from that permanent establishment to another Member State[800].

In the case of foreign companies, in fact, if central management and control becomes located in another country, UK residence will cease and, in that case, a tax charge will be levied on the unrealised capital gains of the company immediately prior to the change of residence[801]. In that case, Section 185 of the Taxation of Chargeable Gains Act (TCGA) 1992 deems the company to have disposed of all its assets at market value immediately before it becomes non-resident and to have immediately reacquired them.

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[800] If the tax due remains unpaid for more than six months, said tax may be recovered from a controlling director or another company belonging to the same group.

[801] The company will have to inform HMRC in advance of its intention to leave the United Kingdom by notice in writing, specifying the tie when the change will occur and including a statement of UK tax payable together with details of the ways that tax is going to be paid. Failure by the company to comply with the notification duty before ceasing to be resident in the United Kingdom may lead to a penalty. See Lee, N. (ed.), *Revenue law: principles and practice*, cited above, 1135.

If, at any later time, the company carries on a trade in the United Kingdom through a permanent establishment, the deemed disposal does not apply to any assets located in the United Kingdom and are used in or for the trade or are used or held by that permanent establishment.

In case a non-resident company residing in another EU Member State carrying on a trade through a permanent establishment located in the United Kingdom transfers out of the UK territory assets that, until the moment of transfer, had been held for the purposes of the permanent establishment's trade, such a transfer will in general give rise to a deemed disposal of the assets at their open market value[802]: in that circumstance, in fact, the assets cease to exist within the scope of UK capital gains tax. This rule applies regardless of whether the permanent establishment in the context of which the assets transferred were used continues to carry on its trade and also regardless of whether the movement of the asset out of the United Kingdom involves the transfer of its ownership to another subject[803].

Moreover, while the transfer of the ownership of an asset from a UK company to an affiliate residing in the United Kingdom does not generally give rise to any tax charge, a transfer of ownership of a certain asset from a UK company to an affiliate residing in another EU Member State may give rise to tax liability, unless a territorial nexus is maintained between such assets and the United Kingdom, i.e. unless the non-resident company has a permanent establishment located in the United Kingdom and uses the assets for the purposes of that permanent establishment's activity.

More in detail, while no tax liability arises in case of a disposal of an asset by a UK company to a corporate affiliate which is fiscally resident in the United Kingdom, the same cannot be said for the case in which the transferee affiliate does not reside in the territory of the United Kingdom: in that circumstance, pursuant to Section 171 of the Taxation of Chargeable Gains Act 1992 (TCGA 1992), the transaction is considered as "fiscally neutral" only if and to the extent that the transferee carries on a trade through a UK permanent establishment and uses the transferred assets in the context of that permanent establishment, which essentially means that the transferred assets, even when held by the non-resident transferee, still remain within the scope of UK capital gains taxation[804].

[802] Section 25(1) TCGA 1992.

[803] An exception is made for the case where the assets are transferred to a corporate affiliate of the transferor which is a company subject to UK corporate taxation: in this case, in fact, the transfer is considered as "fiscally neutral" for the purposes of UK capital gains taxation and no charge to tax arises.

[804] Potgens, F.P.G., van Os, P., Duran, P.H., et al., *The compatibility of exit tax legislation applicable to corporate taxpayers in France, Germany, Italy, the Netherlands, Portugal, Spain and the United Kingdom with the EU freedom of establishment*, cited above, 61.

In all other cases, the disposal of an asset in favour of a non-resident transferee is treated, for the purposes of UK taxation, as conducted at the "open market value" of the disposed asset, so that the transaction gives rise either to a gain or a loss[805].

In light of the above, we can state that there are two cases where the United Kingdom taxes domestic transactions more favourably than cross-border ones involving another Member State, with a consequent possible restriction of freedom of establishment. First of all, the transfer of an asset without a consequent change of its ownership from the United Kingdom to another Member State does not trigger any charge to tax, whereas, on the other hand, a charge to tax arises where a corporate taxpayer established in another Member State with a UK permanent establishment transfers an asset located in the United Kingdom from that permanent establishment to another Member State. Secondly, the transfer of the ownership of an asset from a company established in the United Kingdom (and resident therein) to an affiliate which is another company residing in the United Kingdom does not give rise to any charge to tax; however, the transfer of ownership of an asset from a UK company to an affiliate from another Member State may potentially be chargeable to UK tax, unless the corporate taxpayer established in the other Member State has a UK permanent establishment and uses the transferred asset in the context and for the purposes of that permanent establishment[806].

7. Concluding remarks: "residence" as the key-concept for international taxation.

What can be drawn from all that has been highlighted above is, first of all, the confirmation that the states' choices on whether to implement worldwide, semi-territorial or strictly territorial tax models (and the consequent implications on the debate concerning capital import neutrality and capital export neutrality) have evolved through the years on the ground of reasons related essentially to economic policy rather than principles of social justice or adherence to hypothetical international binding principles.

This has proven to be true for Italy, which has, a long time ago, switched to a "traditional" worldwide tax model characterised by some examples of extraterritorial extension of taxing powers over subjects with arguably feeble ties to the territory of the

[805] Section 171(1A) TCGA 1992.

[806] Potgens, F.P.G., van Os, P., Durand, P.H., et al., *The compatibility of exit tax legislation applicable to corporate taxpayers in France, Germany, Italy, the Netherlands, Portugal, Spain and the United Kingdom with the EU freedom of establishment*, cited above, 62.

Italian State (e.g. measures countering "*esterovestizione*") in pursuit of the practical purpose of fighting tax avoidance. Even France, with its "semi-territorial" tax system for corporate entities resorts to non-territorial measures to extend its taxing powers beyond the borders of its territory and, however, does not extend its territorial tax measures to individuals, who are perceived as more mobile and hardly controllable from the perspective of a territorial tax system. Finally, the United Kingdom has modified its traditionally worldwide tax system towards the implementation of a more territorial model in light of the admittedly practical purpose of attracting business and high-worth individuals to establish their residence within its territory.

All of these evaluations ultimately lead to the confirmation of the conclusions stated at the end of the first chapter of the research, i.e. of the fact that the principle of territoriality (if we were to hypothetically acknowledge it ever existing as an actual principle, with the meaning given to the word "principle" in the international law context) has suffered a progressive demotion from being a guideline for the allocation of taxing of taxing powers amongst countries with regards to transnational items of income, so as to ensure cross-border neutrality of investment, to a mere criterion of economic policy. In light of this progressive "technicalisation" of territoriality, we cannot but agree, therefore, with those authors who have found that what hat has been progressively lost in the evolution of the tax systems at the international level is the "institutional" element of territoriality[807].

The only effective limit to Member States' freedom in choosing on how to shape their fiscal system comes from European Union law, as the analysis of the evolution of the two "case studies" of exit taxation and Controlled Foreign Companies regime has shown.

Another (probably obvious) result that can be drawn from the comparison is that countries charging taxes on income wherever produced or accrued on whoever has a connection of a personal and subjective nature with their territory (often, residents) generally extend their taxing powers on those subjects (non-residents) not having any connection with their territory beside the fact that they produce (part of) their income within said territory, which has led to the coexistence of worldwide taxation for residents and territorial taxation for non-residents, as is the case for Italy, the United Kingdom and, in part, France.

It can also be concluded that, in general terms, worldwide systems entail certain "fiscally territorial" elements with regard to the treatment of residents as well, with the

[807] Sacchetto, C., *Territorialità*, cited above, *passim*.

establishment of "tempered worldwide" tax measures for some specific items of income. This is the case, for example, of income accrued on foreign permanent establishments, which is generally taxed by the state where the permanent establishment is located and is exempted from tax charges on the head office or parent company in its state of residence/establishment. Cross-border dividends are also often exempted from taxation in the state of residence of the subject receiving them, so as to avoid international economic double taxation, thus *de facto* derogating from the worldwide tax structure of the system in favour of a more territorial provision.

The difference between residence and non-residence, and the different nature of the consequences attached to the two statuses, is essential to territorial, or semi-territorial, tax models as well, even though one is often led to the opposite conclusion: the circumstance that the state only taxes those income located within the territory of the state, regardless of them being produced or owned by residents or non-residents, would theoretically imply that the key-concept for the functioning of the system is not the concept of "residence", but rather the definition of what constitutes the actual "source" of the income.

However, almost paradoxically, the concept of residence plays a fundamental role also in identifying the source of the income. The localisation of certain items of income, in fact, may be based on the residence of the subject paying them: this is true, for example, as far as dividends, interest and royalties are concerned, which are generally deemed as being "produced" in the territory of the state if and insofar as they are paid by subjects who reside within its territory. This is also true for employment income, which is considered as originated in the territory where the subject paying the salary is located, resident or established.

A paramount relevance is, therefore, constantly given to the concept of "residence", the true "arbiter" of the match between "source country" and "residence country" in the dialectical relationship for the allocation of taxing powers. The criteria that states resort to in order to define who resides within their territory for tax purposes and who does not currently need to take into account the many ways in which the "resident status" can be manipulated and distorted for avoidance purposes, taking advantage of the fast-paced evolution of transports and communications and, more than anything else, of the mismatches between the definition of "residence" provided by domestic legal orders. The tiebreaker rule enshrined in double taxation conventions is, in fact, hardly all-encompassing and does not provide a uniform way to determine fiscal

residence, with a method that ultimately relies, once again, essentially on domestic provisions.

We have seen how the criteria that states use to determine who is and who is not considered as their resident for tax purposes may be used for actual anti-avoidance aims: this is the case of the Italian measures countering "*esterovestizione*" or of the Italian method of establishing residence on the ground of a formalistic criterion such as being listed in the civil registry of the population.

The relevance attributed to the concept of residence is also demonstrated by the fact that the Court of Justice, in examining the compatibility of Member States' tax provisions with European Union law, has often focused its attention on that concept and on its consequences for the implementation of measures such as unlimited tax liability, with all evident reflections on the interaction between different tax systems and between national taxation and the Treaty freedoms[808]. The actual existence and/or the level of physical presence of a non-resident company in a certain country have been taken into account by the Court of Justice, for instance, in the evaluation of the compatibility of anti-avoidance rules, such as CFC regimes, with the Treaty freedom of establishment, proving essential in order to grant a proper functioning of the Internal Market and of competition.

Starting from these assumptions, the Court of Justice has often wondered whether the attribution to a subject of the qualification of "resident" or "non-resident" is able to impact the effective implementation of the Treaty freedoms by Member States, given that the limited liability to tax connected to the "non-resident" status implies limitations, for instance, to the rights to have negative items of income taken into account for tax purposes in a situation where the same negative items of income would be taken into account for resident subjects. Which has often led the Court to generally stop accepting justifications based on a supposed difference between resident and non-resident entities and subjects. However, the problems will probably persists as long as the issues concerning the criteria for the identification of residents and non-residents will persist, which, according to some, constitutes the main obstacle to reaching a system for the uniform taxation of entities and corporations in the European Union[809].

"Residence" is also the concept on which the entire exit taxation system is grounded: exit taxation, by its nature, is triggered when a certain subject ceases to be

[808] Amatucci, F., *L'influenza della giurisprudenza della Corte di Giustizia UE sulla individuazione dei soggetti passivi IRES*, in Diritto e Pratica Tributaria, 2013, 5, 1079.
[809] Amatucci, F., *L'influenza della giurisprudenza della Corte di Giustizia UE sulla individuazione dei soggetti passivi IRES*, cited above, 1088.

considered as a resident and starts being considered as a non-resident. It is, therefore, evident the definition of what constitutes "residence" is essential to the application of exit tax measures, which, as has already been shown in the previous pages and chapters of the research, is possibly the truest testing ground for a new and integrated vision of a single "Internal Market territory".

Residence does, therefore, appear to be the true key-concept in the current scenario of international tax law and to be paramount, first of all, for the implementation of European Union law, as interpreted by the Court of Justice and enacted by the EU legislature. Nonetheless, European Union still lacks a uniform definition of "residence" for tax purposes: the Court of Justice has not gone further than simply tracing pieces and lines of what could constitute a EU-level definition of the concept and all the Directives concerning (corporate) income taxation simply refer to the definition of "residence" provided by domestic tax laws.

The United Kingdom has tried to provide an almost "mechanic" definition of "residence" with the recently adopted statutory residence test, even though the key-concept for UK taxation has proven to be not "residence", but "domicile". Whether or not this could be a possible way to go for the future depends on the compatibility of such an automatic definition with European Union law and with the reality of the single Member States.

CONCLUSIONS

THE ROAD(S) AHEAD

There is a clearly evident conflict, and some say incompatibility, between the sovereignty and the fiscal jurisdiction of the Member States as traditionally developed at international level and according to general international law (and as described in the first chapter of the research) and the European Union perspective, aiming at the establishment of an authentic Internal Market.

In its (non-tax) judgement on the *Polydor* case[810], the Court of Justice of the European Union ruled that "*the Treaty, by establishing a common market and progressively approximating the economic policies of the Member States, seeks to unite national markets into a single market having the characteristics of a domestic market*"[811]. Statements such as this have traditionally constituted the basis for the Court to acknowledge the existence of a need to "*merge the national markets into a single market bringing about conditions as close as possible to those of a genuine internal market*"[812]. It is certainly correct to state, therefore, that the European Union ultimately aims, or should aim, at the implementation, across all the

[810] Court of Justice of the European Union, 9 February 1982, C-270/80, *Polydor Limited and RSO Records Inc. v. Harlequin Record Shops Limited and Simons Record Limited*.
[811] Similar arguments have been made by the Court in tax cases as well. See, for instance, Court of Justice of the European Union, 5 October 1994, C-381/93, *Commission v. French Republic*; Court of Justice of the European Union, 3 October 2002, C-136/00, *Danner*.
[812] Court of Justice of the European Union, 5 May 1982, C-15/81, *Gaston Schul*.

European Union's territory, of the same conditions as those characterising the domestic market of a single country.

The merging of the existing national markets into a one single market, the territorial dimension of which should coincide with the entire and borderless territory of the Internal Market, however, presupposes the absence of any limitation or restriction to the movement of persons or companies across the "unified territory" and to the conducting of cross-border activities on the part of EU citizens. Coming to the field of taxation, this would imply the coordination of each single national tax system in order to prevent as much as possible the obstacles that taxation could impose on such cross-border movement and would also, therefore, imply necessary limitations to the Member States' freedom in legislating in the matter of taxation, possibly even going further than what has been established by the Court of Justice so far.

However, as argued in the first chapter of the research, a general principle of fiscal territoriality - interpreted as a hypothetical obligation for all states to levy taxes only on items of income which are linked to their territory - does not seem to be embedded in any source of international law, which means, therefore, that states are generally "boundless" in the determination of the extension of their taxing powers in the international arena, being theoretically able to even enact extraterritorial forms of taxation. Which evidently conflicts with all that has been said above with regard to the European Union context.

The fourth chapter of the research has, in fact, shown that, in the European Union context, there still is, to a certain extent, a considerable degree of "compartmentalisation" of the EU territory, which is capable of hindering the unity and integration of the Internal Market. Member States' fiscal sovereignty and the apparent inexistence of any internationally recognised limit to such sovereignty might, therefore, constitute a problem for the integration of the Internal Market[813].

Nonetheless, it is also true that, in practice, countries generally tend to conform to criteria whose application resembles the mechanisms underlying a hypothetical "binding principle of territoriality" as it stands in general international law, as a jurisdiction principle recognising a state's right to legislate on the basis of a territorial connection between a state and a certain subject or object. The Court of Justice of the European Union has consistently held that Member States remain sovereign in determining the connecting factors for levying taxes. However, it is clear that certain

[813] Wattel, P.J., *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power: what is the difference?*, cited above, 144; Monsenego, J., *Taxation of foreign business income within the European Internal Market*, cited above, 456.

consequences stemming from the exercise of their fiscal sovereignty on the part of the Member States are not compatible with the achievement of a truly integrated Internal Market.

As it has been shown through the analysis of the Court of Justice's case law in the second chapter of the research and through the analysis of the national tax systems conducted in the fourth chapter, both the traditional types of territorial connections chosen by states in the design of the extension of their taxing powers, i.e. the "objectively territorial" connection based on source (and the consequent application of a strictly territorial tax system) and the "subjectively territorial" connection based on residence (and the consequent establishment of a system of worldwide taxation), pose certain problems of compatibility with the achievement of a truly integrated Internal Market. The determination of the territorial connection between Member States and taxable income is, therefore, essential in order to understand how to reach the "highest purpose" of the European Union. This is one of the reasons why, as highlighted in the fourth chapter of the present work, it seems safe to say that the key-concept that needs to be defined to the aim of shaping a truly territorially integrated tax system is the concept of "residence" (and, *a contrario*, of "non-residence").

As to the necessary coordination of national tax laws in the EU context, some have argued, following the notion of a proper Internal Market as enshrined in the Treaties and developed by the Court of Justice's jurisprudence, that, in the context of the European Union the laws of only one Member State should be applied to a cross-border economic operation[814]. This view comes, to a certain extent, quite close to the notion of the principle of territoriality as developed in the context of international tax law, i.e. the statement that the laws of only one country are applied within its territory[815]. The application of this reasoning would imply that cross-border items of income would have to be taxed, within the territory of the European Union, according to a single set of tax rules, i.e. pursuant to the tax law of only one Member State, that is to say either the Member State of source or the Member State of residence.

This somehow utopic solution would allow the elimination of juridical double taxation in the context of the Internal Market, since there would be no "parallel exercise" of taxing rights on the part of more than one Member State. Such a solution would, therefore, imply the need to choose which tax model better fits the purposes and nature of the European Union.

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[814] Vanistendael, F., *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, cited above, 142.

[815] Monsenego, J., *Taxation of foreign business income within the European Internal Market*, cited above, 351.

The question as to which system best fits in the context of the European Internal Market should find its answer in the objectives that the functioning of the Internal Market itself pursues, first of which, as recognised by the Court of Justice, is the achievement of the highest possible level of efficiency by allowing the Internal Market to operate in the same way as a national market would, with the attainment of an open market economy and unadulterated competition.

European Union law is not, at least apparently, oriented towards inter-nations fiscal equity, since it is generally up to the Member States to determine the allocation of tax revenue amongst them in a way that they deem as fair and equitable[816]. Nevertheless, there has been an intense debate on whether or not the European Union legal order favours a model following capital export neutrality or a model built to ensure capital import neutrality. A question to which the "case-by-case" approach of the Court of Justice does not certainly provide an easy answer.

Part of the legal doctrine has argued that pure territorial taxation for both residents and non-residents would be, in the European Union context, a simple and neutral system, on the basis of economic allocation of the results of business activities, removing both international inconsistencies deriving from international tax law and restrictions to free movement[817]. "Pure territoriality"[818] would arguably also be consistent with the principle according to which Member States cannot treat nationals of other Member States worse than how they treat their own nationals.

The application of such a model on a large scale would involve a base exemption in the Member State of residence of all positive and negative items of income accrued abroad and territorial allocation of costs[819]. The uniform implementation of such a model on the part of all Member States (irrespective of them being "residence countries" or "source countries" in the specific cases at issue) would, according to this thesis, remove every problem connected to extraterritorial taxation and the need for complicated mechanisms in order to prevent the effects of double taxation[820].

On the other hand, some authors have spoken against the compartmentalisation of tax bases that would be generated by the adoption of purely territorial tax models on the part of European Member States (even though the Court of Justice, as it has been

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[816] Garcia Prats, F.A., *EC law and direct taxation: towards a coherent system of taxation?*, cited above, 6.
[817] Terra, B.J.M., Wattel P.J., *European tax law*, cited above, 457.
[818] Wattel, P.J., *Capital export neutrality and free movement of persons*, cited above, 115.
[819] Wattel, P.J., *Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity: a plea for territoriality*, cited above, 201. On a similar point, see also Amatucci, F., *Limited tax liability of non-resident companies and freedom of establishment*, in EC Tax Review, 2003, 4, 202. On the same issue, Vanistendael, F., *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, cited above, 136.
[820] Wattel, P.J., *Red herrings in direct tax cases before the ECJ*, cited above, 88.

argued above, seems to have accepted such effect as compatible with EU law)[821]. More specifically, it has been argued that, in the context of the European Union, in absence of any unifying or harmonising measure on the point, worldwide taxation ensures, for both individuals and corporations, horizontal cross-border loss relief. In other words, worldwide taxation ensures that foreign losses can be deducted from positive domestic income, thus ensuring that such losses can be used by the taxpayer in order to reduce his/her/its overall tax burden even in absence of any positive item of income in the country where the losses have arisen, and, ultimately, complying with principles such as tax progressivity and ability-to-pay. This is what legal doctrine has defined as "always-somewhere approach", especially after the *Marks & Spencer* judgement.

These are some of the reasons why part of the European tax law scholars have stated that the most appropriate solution would be the implementation, by both the Member State of residence and the Member State of source, at least as far as individuals are concerned, of worldwide taxation with double taxation relief (essentially by way of the credit method) for both resident and non-resident taxpayers. According to its supporters, this option would ensure progressivity also on foreign-source income, a correct division of personal tax allowances (which are not related to the country where the source of the income is located) and cross-border loss compensation[822].

Moreover, the simple adoption of a purely territorial tax system would have unacceptable consequences for states, especially with regards to income characterised by a high level of mobility. The immediate consequence of the adoption of such a system would be to leave taxpayers with too much liberty in the shaping of their interests, leaving them with the actual possibility to choose the tax system applicable to their income or transactions. The system would, therefore, need so many corrective measures that it would end up being completely different from a "purely territorial" model.

With regard to the Court of Justice's case law, it should also be noted that, as it has been shown above, the Luxembourg Judges have generally recognised that a different treatment of residents and non-residents in the field of taxation does not generally constitute a breach of EU law, since the two positions are not, in principle, comparable. However, according to the Court's decisions, exceptions to this general principle could and should be made when, in practice, residents and non-residents find

[821] See, for example, Monsenego, J., *Taxation of foreign business income within the European Internal Market*, cited above, 259.
[822] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 457. Nonetheless, the Authors acknowledged the administrative difficulties arising from the application of the proposes model of taxation, since, for example, the Member State of source would have to be able to ascertain the worldwide income and the personal circumstances of non-resident taxpayers.

themselves in objectively comparable situations. In this case, the Member State of source would be obliged to granting the non-resident taxpayer the possibility to avail itself of the same tax treatment reserved to residents of that Member State.

This position, however, has been, and still is, upheld by the Court of Justice only with regard to individual taxpayers, whereas a different reasoning seems to apply as far as corporations or juridical persons are concerned. The *ratio* behind this different treatment of physical and juridical persons is linked to the need to ensure the implementation of the ability-to-pay principle, which, even though not enshrined in any particular piece of EU law, has been recognised by the Court as paramount in order to ensure the effectiveness of the principle of non-discrimination. The basic reasoning is that, if taxes should be assessed on the basis of an individual taxpayer's personal situation by virtue of the ability-to-pay principle, the same does not need to apply with regard to corporations, which, by their nature, do not have any "personal situation" that should be taken into account.

Notwithstanding the opinion expressed by legal scholarship, what appears to be certain is that both "objectively territorial" taxation and worldwide taxation, however, raise issues of compatibility with the European Union's objective to attain a properly functioning and truly integrated Internal Market. The analysis of the Court of Justice's case law on direct taxation, territoriality, discriminations and restrictions has proven so. European Union law, therefore, does not clearly point to which of the two general criteria for the exercise of state taxing rights best suits the objective of a more integrated Internal Market. Moreover, no clear indication as to which country between the Member State of source and the Member States should have priority to tax a certain item of income comes from the analysis of secondary EU law concerning direct taxation. The Court even accepts the admissibility of the absence of any effective double tax relief, provided neither Member State discriminates between cross-border situations and purely domestic ones.

Also the Court of Justice of the European Union considers both capital import neutrality and capital export neutrality perspectives as compatible with primary EU law and not hindering the aim of realising a proper functioning of the Internal Market[823], since, according to the Judges, both perspectives do not result in a higher tax burden on foreign-source income than on domestic income. Especially since European Union law (or better European Union primary law) does not even require Member States to prevent international double taxation: under the *Kerckhaert-Morres*, *Damseaux* and *Block* doctrine,

[823] Kemmeren, E.C.C.M., *The internal market approach should prevail over the single country approach*, cited above, 575.

in fact, if, in a cross-border situation, no relief from double taxation is available and neither of the two Member States involved discriminates against non-residents or against foreign-source income (i.e. if double taxation is caused by the mere exercise in parallel of taxing powers by two Member States at the same time), then, under European Union law, there is no remedy available to the taxpayer concerned, in absence of positive integration.

Part of the legal doctrine has, nonetheless, argued that, if the Court of Justice were competent to make a choice between the two traditional tax models (worldwide taxation or "territorial" taxation), the principle of source country entitlement should prevail[824], while the Member State of residence should have to prevent double taxation (e.g. by exempting all foreign-source income from tax, adhering to a purely territorial model, or by granting a proportionate tax reduction or by crediting the foreign tax paid), as it was the economy of the Member State where the income had its source to offer the taxpayer the economic opportunity to earn the income on which tax is levied[825-826].

If examined from a certain perspective, the Court of Justice's case law would actually seem to favour a tax model based on pure territorial taxation over a fiscal model based on worldwide taxation. This hypothetical preference could be inferred, for example, from the Court's decisions on CFC regimes, which are inherently "extra-territorial" by nature, since the Court of Justice has essentially limited - though not disallowed - the implementation of such provisions to "extreme cases" (i.e. "*wholly artificial arrangements*"), with an approach that has recently been picked up and broadly confirmed by the EU legislature with the Anti-Tax Avoidance Directive, as shown in the third chapter of the dissertation. However, as it was shown in the previous pages of the research, the Court has gradually accepted some forms of extra-territorial exercise of taxing powers, acknowledging, to some extent, the Member States' rights to protect their tax bases from tax avoidance practices and the lawfulness of the establishment of an "extended worldwide liability to tax".

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[824] Kemmeren, E.C.C.M., *Double tax conventions on income and capital and the EU: past, present and future*, cited above, 159.

[825] Terra, B.J.M., Wattel, P.J., *European tax law*, cited above, 131.

[826] However, this was not the position held by the 1962 Neumark Report, which held that it seemed neither necessary nor desirable to reach an uniform implementation, within the European Union, of the principle of income taxation at source, since this would have arguably led to the creation of situations contrary to those of a proper Internal Market, being it able to deviate from taxation of the overall income of the taxpayer, ability to pay and progressivity. The Report concluded that double taxation should be completely avoided (which was confirmed also by the subsequent 1992 Commission Report of the Committee of Independent Experts on Company Taxation, also known as "Ruding Report"), but that, however, each taxpayer should be ultimately taxed according to his/her/its economic capacity in accordance to the provisions of his/her/its country of residence. On the point, see Kemmeren, E.C.C.M., *Double tax conventions on income and capital and the EU: past, present and future*, cited above, 161. See also the Commission Communication to the Council and to the European Parliament "subsequent to the conclusions of the Ruding Committee indicating guidelines on company taxation linked to the further development of the Internal Market", SEC(92)1118, 26 June 1992.

Another proof of the Court of Justice's preference for territorial tax regimes could be found in its case law on group relief of cross-border losses. The Court's "final losses doctrine", in fact, treats the obligation of the Member State of establishment of the parent company's to allow the relief of foreign losses as a "last resort" that could be advocated only in "extreme cases", i.e. when such losses would not be used anywhere else in the Internal Market. On the other hand, however, a purely territorial tax model and consequent allocation of taxing powers amongst Member States was found to be non-compliant with European Union primary law when preventing the deduction of losses incurred by foreign subsidiaries[827].

It is also true, in fact, that this approach, which was described as "always somewhere approach", is interpreted, by part of the legal doctrine, as a demonstration of the exact opposite theory, i.e. the Court's preference for a tax model based on capital export neutrality. As shown above, in fact, the principle of tax territoriality was found to be in contrast with European Union law when preventing enterprises to have the losses incurred in foreign territories taken into account in their Member State of residence for tax purposes. The lack of cross-border loss relief that would follow from the implementation of purely territorial tax systems would indeed constitute a considerable obstacle to the proper functioning of the Internal Market, as acknowledged also by the Commission.

However, the fact that the Court of Justice, in cases like *Gilly*[828], *Van Hilten* and *Thin Cap GLO*, seems to recognise and sometimes also to adopt the OECD practice of international tax law (in particular, the solutions provided by the OECD Model Convention and its Commentary) seems to go in the opposite direction, since the OECD Model has predominantly adopted a residence-based system including a tax credit system for the elimination of double taxation. Moreover, in its *Gschwind* judgement[829], the Court recognised that current international tax law is generally based on the "residence principle" in the allocation of taxing powers amongst countries in circumstances with cross-border elements.

On the other hand, however, conclusions such as those reached in *Schumacker* - where the Court ruled that the Member State of source must take into account the personal and family circumstances of a non-resident individual taxpayer, if said taxpayer obtains his/her income entirely or predominantly in the Member State of

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[827] Monsenego, J., *Taxation of foreign business income within the European Internal Market*, cited above, 444.
[828] Where the Court held that it is not unreasonable for Member States to base their bilateral agreements on international practice and on the OECD Model Convention.
[829] Court of Justice of the European Union, 14 September 1999, C-391/97, *Gschwind*.

source and does not receive sufficient income in his/her Member State of residence to be subject to taxation in a way enabling him/her to have such circumstances taken into account therein - seem to opt for a solution in the sense of favouring capital import neutrality and taxation at source[830].

More recent case law of the Court of Justice has allowed a certain use of worldwide taxation for the purposes of prevention of tax avoidance (see, for instance, *Van Hilten*, *Argenta* and *Cadbury Schweppes*) and the same has been done by the recently adopted Anti-Tax Avoidance Directive. The Member States' need to prevent tax avoidance has thus become paramount in the more recent analysis of the Court of Justice, with the Luxembourg Judges recognising the possibility for Member States to enact objectively discriminatory or restricting measures to that aim and the need of prevention of tax avoidance becoming a fundamental support of the admissibility of the sovereign choices made by Member States in the allocation of their taxing powers.

In light of the above, it seems safe to say that the Court of Justice does not seem to explicitly lean towards a tax model pursuing neutrality in either the Member State of residence or the Member State of source, aiming at the elimination of discriminatory tax treatments from the perspectives of both Member States. Some have found this approach to be ultimately inconsistent[831]. However, it should be recalled that it is not the Court of Justice's role, according to the institutional structure of the European Union, to create and implement tax policies, being it something that is (and better be) left to the legislature. The Court rules on the prohibition of discriminations on grounds of nationality, irrespective of whether the hypothetical discrimination is a consequence of the tax jurisdiction of the Member State of source or the Member State of residence.

On the other hand, the analysis of EU secondary law on direct taxation, as conducted in the third chapter of the research, would seem to show an overall tendency, on the part of the EU legislature, towards the implementation of fiscal structures based on worldwide taxation and on priority to tax cross-border items of income being granted to the country of residence of the taxpayer. As it has been shown in the previous pages of the present work, this assumption is contradicted by the analysis of European Union positive law on direct corporate taxation, where, exception made with reference to the Merger Directive, one cannot but observe a general tendency towards recognising the Member State of residence the primary or exclusive right to tax certain items of income.

[830] Kemmeren, E.C.C.M., *Double tax conventions on income and capital and the EU: past, present and future*, cited above, 173.
[831] Graetz, M.J., Warren Jr., A.C., *Income tax discrimination and the political and economic integration in Europe*, in Yale Law Journal, 2006, 4, 1217.

Which, according to some, could be interpreted as a sign that the European Union policy-maker favours a model based on worldwide taxation over a model adhering to strict territoriality.

This is what may be derived, for instance, from the analysis of the Parent-Subsidiary Directive, as interpreted by the Court of Justice, and of the Interest and Royalty Directive, but this tendency would appear to have been somehow confirmed, even though for different purposes, by Articles 7 and 8 of the Anti-Tax Avoidance Directive on CFC legislation, expressly allowing forms of extraterritorial exercise of taxing powers on the part of the Member States, even though in "extreme cases" where there is a seriously pressing need to curb international tax avoidance.

It should be borne in mind, however, that all pieces of EU secondary law on direct taxation are by nature applicable only to some specific cross-border issue and do not in any way aim at providing a clear all-encompassing view of how income taxation should work in the context of the Internal Market.

Moreover, as far as the debate between capital import neutrality and capital export neutrality is concerned, it has been shown in the previous pages that secondary European Union law treats them both as equivalent as far as Member States' obligations are concerned. The Parent-Subsidiary Directive allows Member States a choice between the two methods; the Arbitration Convention embraces both methods; the CCCTB proposals exempt profit distributions received and income from a permanent establishment in a third country.

The attempt to attain the purpose of a fully integrated and functioning Internal Market has, so far, led the European Union institutions (especially, but not exclusively, the Court of Justice) to limit national fiscal sovereignty only in specific circumstances, without, however, ever proposing alternative tax models to be implemented in the EU context. It has been convincingly argued that the case law of the Court of Justice, even though sometimes showing a certain degree of "interventionism" in the choices and policies of the Member States in the field of direct taxation, disrupting the "balanced allocation of taxing powers" created by the Member States in the exercise of their sovereign prerogatives, is, however, not sufficient in order to attain the purpose of a fiscally integrated Internal Market[832].

It is commonly accepted that the Court of Justice of the European Union is the main driver of economic integration amongst Member States. The Court has, in fact, in

[832] Monsenego, J., *Taxation of foreign business income within the European Internal Market*, cited above, 456; Muten, L, *Will case law do?*, in Hinnekens, L. (ed.), *A vision of taxes within and outside European borders*, Amsterdam, 2008, 658.

exercising it role conferred upon it by the Treaties (i.e. to ensure that in the interpretation and application of European Union law the law is observed and to ensure an uniform interpretation of European Union law across all Member States), the power to ensure the enforcement and implementation of the fundamental Treaty freedoms and of the general principle of non-discrimination, and it has actually used this power extensively over the years to intervene on the tax systems of the Member States in relation to cross-border transactions and circumstances.

The process of "negative integration" that is being carried out by the Court of Justice of the European Union has, according to part of the legal doctrine, led to a *de facto* modification of the division of competences between the European Union and the Member States and, according to some, to an infringement of the above-mentioned general principles of conferral and subsidiarity[833].

Many have criticised the influential, and some say excessive, role played by the Court of Justice in matters concerning direct taxation. This criticism ranges from the specific critique of single judgements of the Court to a general disapproval of the Court's decision of applying its traditional "free movement approach" to direct tax cases[834].

Given the present *acquis communautaire* in the field of direct taxation, and the corresponding extension of the fiscal sovereignty of Member States in the allocation of taxing powers amongst them, there is not much that the Court of Justice has the power to do about the fiscal consequences of the territorial fragmentation of the tax base within the European Internal Market[835]. According to many voices that have spoken out on the point, the Court should not allocate or divide taxing powers amongst Member States and

[833] Sacchetto, C., *Member States tax sovereignty: between the principle of subsidiarity and the necessity of supranational coordination*, cited above, 807; Rasmussen, H., *Between self-restraint and activism: a judicial policy of the European Court*, in European Law Review, 1988, 37.

[834] De La Feria, R., Fuest, C., *Closer to an Internal Market? The economic effects of EU tax jurisprudence*, Oxford University Centre for Business Taxation, Working Paper 11/12. As highlighted by the Authors, the basis for the criticism to the Court's case law in the field of direct taxation tends to be the Court's lack of competence in the field, which threatens national tax sovereignty, the Court's lack of awareness of the particularities of tax law and the Court's lack of concern for the potential budgetary implications of its decisions. On the point, see also Weber, D., *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, cited above, 585; Bizioli, G., *Balancing the fundamental freedoms and tax sovereignty: some thoughts on recent ECJ case law on direct taxation*, cited above, 133; Avery Jones, J., *Carry on discriminating*, in British Tax Review, 1995, 6, 525; Kingston, S., *The boundaries of sovereignty: the ECJ's controversial role applying Internal market law to direct tax matters*, cited above, 287; Wattel, P.J., *Red herrings in direct tax cases before the ECJ*, cited above, 81; Thommes, O, *Effect of ECJ decisions on budgets of EU Member States: EC law without mercy?*, in Intertax, 2005, 12, 560; Vanistendael, F., *The ECJ at the crossroads: balancing tax sovereignty against the imperatives of the Single Market*, cited above, 413; Seer, R., *Le fonti del diritto comunitario ed il loro effetto sul diritto tributario*, cited above, 51; De Hosson, F., *On the controversial role of the European Court in corporate tax cases*, in Intertax, 2006, 34, 294.

[835] It has been observed that, since the Court is an unelected body and its Judges are appointed by common accord of the governments of Member States through a system by way of which, essentially, each Member State nominates a judge and the nomination is ratified by the other governments, it could mean that too much power is given to the small Member State that has the power to appoint one judge in the same way as the large Member States. See, amongst others, Wattel, P.J., *Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity: a plea for territoriality*, cited above, 200.

should not prescribe which of two concurring jurisdictions should prevail or should remedy double taxation. Therefore, it has been highlighted that the Court should not deal with problems such as mismatches in income characterisation, transfer pricing, conflicts of jurisdictions, income attribution to persons, prevention of double taxation and other issues deriving from the division of the tax base over more than one jurisdiction, which can and should be solved only by making jurisdictional priority choices of a purely political nature[836].

One of the reasons why the "creative approach" of the Court of Justice to the topic of direct taxation and, in particular, to the allocation of taxing powers amongst Member States has been also harshly criticised by legal scholarship is that the Luxembourg Judges cannot but resort to a "case-by-case" approach, which, on one hand, is, by its nature, inadequate to promote uniform and general principles and, on the other hand, poses some consequent problems with regards to the certainty of the law, especially as far as the position of the Member States is concerned, since Member States are greatly limited in their possibilities to plan a "fiscal strategy" given the uncertainty of the Court's approach to the possibility of limits to their tax sovereignty.

It has been argued that the Court of Justice's case law in the field of direct taxation suffers from the lack of a clear identification of objectives that, in the Internal Market context, could enable the development of sounder national and EU tax policies, which would make it difficult to come up with consistent parameters and principles that could be used by Member States as "interpretative guidelines" in the drafting of their respective tax laws[837].

For all of these reasons, if a choice needs to be made on the fiscal integration of the Internal Market, it should be made only by the European Union legislature, which should be called to decide on whether priority should be granted either to a territorial connection *lato sensu*, which would imply the application of a tax model based on residence (or another criterion of connection with the territory of the Member State) and, thus, to worldwide taxation, or to a territorial connection *stricto sensu*, i.e. to purely territorial tax systems based on an objective connection with the territory of the Member State.

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[836] Of a different opinion is, for example, Maduro, according to which "*contrary to the traditional conception of judicial activism addressed to the protection of minorities against the democratic majority's will, European judicial activism can better be described ad majoritarian activism: promoting the rights and policies of the larger European political community (the majority) against the 'selfish' or autonomous (depending on the point of view) decisions of national policies*". See Maduro, M.P., *We the Court. The European Court of Justice and the European Economic Constitution. A critical reading of Article 30 of the EC Treaty*, London, 1998, 11.

[837] Garcia Prats, F.A., *Revisiting Schumacker: source, residence and citizenship in the ECJ case law on direct taxation*, in Richelle, I., Schön, W., Traversa, E. (eds.), *Allocating taxing powers within the European Union*, Brussels, 2013, 4.

Resorting to a normative solution through positive integration seems to be the preferable road ahead[838]. Some authors, starting from the assumption that the interactions between direct taxation and the European Union legal order are too relevant to be left merely to the principle of subsidiarity and to a hypothetical - and quite slow - harmonisation process, have advocated the need to abolish the unanimity requirement in the field of harmonisation of direct taxes, especially acknowledging that international double taxation constitutes, in practical terms, a considerable hindrance to the exercise of Treaty freedoms and that certain cases of double taxation may only be eliminated by a coordinated legislative action conducted at an EU level, not being it appropriate and correct for the Court to solve such problems by making actual political choices[839].

An all-encompassing normative intervention of the EU lawmaker such as that envisaged above does appear, however, quite difficult to attain and perhaps utopic, especially in the absence of any direct taxing power conferred on the European Union in the field of income taxation.

Of course the situation would be considerably different, at least in the field of corporate taxation, if corporate income tax were to become, wholly or partially, one of the European Union's own financial resources. It has been argued that, in a hypothetical CCCTB system which would partially constitute an EU resource, transfer of losses in one Member State against profits of another Member State should be the rule, because in such a system profits and losses would only have consequences for the European Union treasury, which means that, since the European Union would bear all positive and negative consequences, the same European Union would have the right to influence the allocation of tax bases between countries[840].

Amongst the solutions that have, so far, been envisaged in order to reach such a purpose, as alternatives to the positive integration by way of directives, which seems somehow utopic, there is the establishment of fundamental principles of EU law in the field of taxation, amongst which the ability-to-pay principle would have to be listed, and possibly enshrined in a sort of "European constitution" which, like national constitutions, would have to deal with taxation as well. However, this possibility does

[838] This opinion is supported, amongst others, by Sacchetto, C., *Member States tax sovereignty: between the principle of subsidiarity and the necessity of supranational coordination*, cited above, 811; Wathelet, M., *Direct taxation and EU law: integration or disintegration?*, in EC Tax Review, 2004, 2; Vanistendael, F., *The ECJ at the crossroads: balancing tax sovereignty against the imperatives of the Single Market*, cited above, 413. *Contra*, see, for example, Melis, G., Persiani, A., *Trattato di Lisbona e sistemi fiscali*, in Salvini, L., Melis, G. (eds), *L'evoluzione del sistema fiscale e il principio di capacità contributiva*, Rome, 2014, 306.

[839] Vanistendael, F., *The ECJ at the crossroads: balancing tax sovereignty against the imperatives of the Single Market*, cited above, 419; Van Thiel, S., Ratträ, C., Meër, M., *Corporate income taxation and the Internal Market without frontiers*, in European Taxation, 1990, 11, 326.

[840] Vanistendael, F., *Ability to pay in European Community law*, cited above, 134.

not currently seem in any way practicable, especially after the results of the latest consultations on a project for a European Constitution[841].

A more "sectorial" approach should then be evaluated.

For instance, the EU lawmaker should acknowledge that the concept of "residence", as highlighted by the analysis of national tax laws conducted in the fourth chapter of the research, appears to be the true key-concept in the current scenario of international tax law, with a paramount relevance for the implementation of European Union law, as interpreted by the Court of Justice and enacted by the EU legislature. Nonetheless, European Union still lacks a uniform definition of "residence" for tax purposes: the Court of Justice has not gone further than simply tracing pieces and lines of what could constitute a EU-level definition of the concept and all the Directives concerning (corporate) income taxation simply refer to the definition of "residence" provided by domestic tax laws.

Perhaps, therefore, the European Union legislature should evaluate the possibility to establish a common definition of "residence", thus going beyond the current approach which is based merely on a reference to the domestic notions of the concept.

Another unsolved issue with a great impact on the fiscal integration of the Internal Market issue relates to double taxation.

The Commission has frequently voiced its opinion according to which double taxation is incompatible with the proper functioning of the Internal Market[842]. Moreover, on this point, it has been correctly highlighted that, in the context of the European Union, the allocation of taxing powers amongst Member States is not so much the result of a choice on whether or not to tax income having its source in a foreign territory, but rather the result of the technique used to eliminate or reduce double taxation[843]. If the choice is for a credit system, both the residence Member State and the source Member State share tax jurisdiction, which means that the argument of the balanced allocation of

[841] Garcia Prats, F.A., *EC law and direct taxation: towards a coherent system of taxation?*, cited above, 26.

[842] See, for instance, the Discussion paper on "*Taxation in the European Union*", 20 March 1996, SEC(96) 487 final, where the Commission clearly stated that "*the Single Market is clearly not compatible with either double taxation of the same taxable base or no taxation at all*". On the same point, see also the Working Document on "*EC law and tax treaties*", 9 June 2005, DOC(05) 2306, which reads: "*it is clear that for nationals of Community countries exercising their basic rights under the Treaty, being taxed in different ways because of their nationality or place of residence and, in particular, the risk of being taxed twice on the same income because of the different, uncoordinated national tax arrangements existing within the Community, are obstacles to the smooth functioning of the Internal Market*". Furthermore, see the Communication on "*The contribution of taxation and customs policies to the Lisbon Strategy*", 25 October 2005, COM(2005) 532 final: "*double taxation, tax-related business restructuring costs and more general differences between Member States' tax rules mean that firms may prefer to operate domestically rather than in another Member State. These are significant obstacles to achieving the full benefits of a competitive Internal Market. The removal of these barriers would help create new opportunities for market entrants, and the resulting competition would spur investment and innovation. Moreover, the reduction in costs associated with the removal of these tax barriers would contribute to enhancing the competitiveness of the EU productive sector*". See also, finally, the Commission Communication on "*Coordinating direct tax systems*", 19 December 2006, COM(2006) 823 final.

[843] Vanistendael, F., *Ability to pay in European Community law*, cited above, 133.

taxing powers amongst Member States loses a considerable part of its relevance. Nonetheless, even where the choice is for an exemption system, some residence Member States (e.g., the Netherlands) have been allowing deduction of foreign losses, in spite of the exemption, thus altering the balance of the allocation of tax bases.

It has also been argued that an override of the limits posed by the bilateral nature of double taxation conventions in favour of a possibly multilateral and integrated approach can take place only in a supranational context, with the intervention of European Union institutions through positive integration[844]. This process would necessarily call for the re-designing of the principle of subsidiarity and for the tracing of new lines between what cannot and what should the Member States delegate to the European Union.

Therefore, an EU-level intervention with regards to double taxation could probably constitute a first, and perhaps more easily attainable, step towards the realisation of a truly fiscally integrated Internal Market. An option would thus be the enactment of a "European Union Model Convention for the prevention of double taxation" or, even better, a multi-lateral EU tax treaty on which the Court of Justice would have the power and competence to rule[845-846].

The introduction of a general prohibition of double taxation in the European Union based on the fundamental Treaty freedoms and, more in general, by the need to ensure the proper functioning of the Internal Market, possibly through a multilateral instrument such as a EU double taxation convention, would undoubtedly constitute a first step towards a fiscally integrated Internal Market, adopting a definition of

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[844] Sacchetto, C., *Il diritto internazionale tributario tra norme del sistema costituzionale italiano, effettività ed utopia*, cited above, 321. According to the Author, in particular, the choice faced by Member States is between "surrendering" part of their sovereignty and accepting that such sovereignty should be limited and conditioned by external forces, such as the intervention of the Court of Justice's case law. If Member States were to opt for the first solution, the result, according to the Author's opinion, would be a qualitatively different limitation of their sovereignty, characterised by higher possibilities to control the process in terms of democratic representation, rationality, neutrality and justice. On the point, see also McLure Jr., C., *Globalisation, tax rules and national sovereignty*, cited above, 328.

[845] These solutions are similar to those conceived by the European Commission in its 2005 Working Document on "EC law and tax treaties", TAXUD E1/FR DOC (05) 2306, 9 June 2005. In this document, the Commission envisaged five possible solutions to the problem of elimination of double taxation in the Internal Market: 1) the replacement of all the intra-EU bilateral tax treaties with a directive; 2) the conclusion of a multilateral double taxation convention by all Member States, supported by binding arbitration powers given to the Court of Justice; 3) the introduction of a European Union Model Double Taxation Convention as a Commission Recommendation, which seemed to be the option which the Commission preferred; 4) the issuance of Commission Recommendations providing guidelines on residence taxation and non-discrimination; 5) the introduction of a most-favoured-nation clause in tax treaties. On the point, see Kemmeren, E.C.C.M., *Double tax conventions on income and capital and the EU: past, present and future*, cited above, 166. A similar solution has been suggested, *inter alia*, by Garcia Prats, F.A., *Revisiting Schumacker: source, residence and citizenship in the ECJ case law on direct taxation*, cited above, 41.

[846] A similar solution has been suggested, *inter alia*, by Garcia Prats, F.A., *Revisiting Schumacker: source, residence and citizenship in the ECJ case law on direct taxation*, cited above, 41; Gutmann, D., *How to avoid double taxation in the European Union?*, in Richelle, I., Schön, W., Traversa, E. (eds.), *Allocating taxing powers within the European Union*, Brussels, 2013, 68; Pires, M., *Le fonti del diritto comunitario e il diritto internazionale*, cited above, 146.

"territory" resembling the one implicitly developed in the field of exit taxation by the Court of Justice and, now, by the Anti-Tax Avoidance Directive[847].

The question would, however, always be how to determine which of the Member States involved in a cross-border situation would be obliged to remove the prejudicial effects of double taxation, thus establishing a sort of "priority rule" between the Member State of residence and the Member State of source. Once again, we come back to the dialectical relationship between territorial taxation and worldwide taxation.

It is the opinion of a large part of legal scholarship that double taxation conventions are relevant economic policy instruments in establishing the proper functioning of the European Union's Internal Market[848]. One of the solutions would be to consider both Member States involved as jointly and severally liable to avoid double taxation, implying that each Member State has an independent obligation to grant tax relief[849]. This is probably the opinion voiced in 2003 by the Commission, analysing a case concerning double inheritance taxation in France and Germany, where the Commission took "*the view that the two States are jointly responsible for arriving at an arrangement regarding taxation which respects the petitioner's rights. It is true that if tax had not been levied in France, this being contrary to the principles widely recognised under international tax law and embodied in the OECD Model Convention, the level of tax payable in Germany would not have been reduced to zero. The Commission recognises that this is unsatisfactory as far as the German exchequer is concerned. However, a solution should not be sought at the expense of the individual citizen by requiring cumulative payment of two sets of estate tax but must be achieved through agreement between the two States concerned*"[850].

A similar scenario was suggested by the Commission in its 2003 Communication on "*Dividend taxation of individuals in the Internal Market*"[851], where the Commission argued that higher taxation of cross-border dividends should be viewed as a restriction of the freedom of movement of capital, also concluding that, where a tax treaty grants the source Member State the right to levy a withholding tax and provides that the Member State of residence has to grant the relative credit to the taxpayer, the Member State is obliged to grant that credit, thus preventing double taxation, not only by virtue of the

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[847] See Chapter 2, paragraph 9, and Chapter 3, paragraph 5.

[848] Kemmeren, E.C.C.M., *Double tax conventions on income and capital and the EU: past, present and future*, cited above, 157, according to which "*a DTC also creates an internal market, but a bilateral one between the contracting States and at a lower degree than the internal market of the EU*" and therefore "*the aim of creating an internal market, DTCs appear to have in common with the TEU and TFEU*".

[849] Lehner, M., *A significant omission in the Constitution of Europe*, cited above, 337.

[850] Commissions response to Petition 626/2000 by Mr. Schuler, 25 January 2007, cited by Kofler, G., *Fundamental freedoms and juridical double taxation*, cited above, 43.

[851] Communication from the Commission to the Council the European Parliament and the European Economic and Social Committee on Dividend Taxation of Individuals in the Internal Market, COM(2003)810, 19 December 2003.

bilateral tax treaty concerned, but also under European Union law. Therefore, notwithstanding the fact that such a statement was made in a time where Article 293 EC Treaty had not been repealed yet, the Commission's position would seem to be that relief of juridical double taxation is required under the fundamental Treaty freedoms (which have not been repealed) and that, in case of the stipulation of a bilateral tax treaty between two Member State, priority for which Member State should relieve double taxation under EU law should be determined by making reference to that tax treaty[852].

Another solution would be to determine which of the Member States should be "more responsible than the other" for the unrelieved double taxation[853]. One option with regard to this possibility would be to make reference to the OECD Model Convention, which is frequently relied upon by the Court of Justice and, according to part of the legal doctrine, seems to have become a sort of "European standard"[854], even though the Court of Justice has ruled that international standards do not form part of European Union law[855].

Aside from this opinion of the Court, the option, voiced by some legal scholars, of referring to the OECD Model in the shaping of the allocation of taxing powers (and in the consequent attribution of the obligations to relieve double taxation) amongst Member States cannot, in any case, but be met with approval, of course, with the unavoidable objection that, as it has been highlighted in the previous chapter of the present research, the OECD Model Convention is nothing but a "model", with absolutely no binding value whatsoever.

Another field that would certainly benefit from a EU-level intervention, which could not but be through a directly binding and possibly multilateral instrument, would be the rules concerning cross-border loss relief. Even though the "final losses criterion"

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[852] Kemmeren, E.C.C.M., *Double tax conventions on income and capital and the EU: past, present and future*, cited above, 161.

[853] Vanistendael, F., *Does the ECJ have the power of interpretation to build a tax system compatible with the fundamental freedoms?*, cited above, 63.

[854] Kofler, G., *Fundamental freedoms and juridical double taxation*, cited above, 43; Lehner, M., *The influence of EU law on tax treaties from a German perspective*, in Bulletin for International Fiscal Documentation, 2000, 461; Vanistendael, F., *The ECJ at the crossroads: balancing tax sovereignty against the imperative of the Single Market*, cited above, 419; Wouters, J., Vidal, M., *An international lawyer's perspective on the ECJ's case law concerning the OECD Model Tax Convention and its Commentaries*, in Hinnekens, L., Hinnekens, P. (eds.), *A vision of taxes within and outside European borders*, The Hague, 2008, 989.

[855] See, for example, Court of Justice of the European Union, 16 July 2009, C-128/08, *Damseaux* ("*Although such an attribution of powers would comply, in particular, with the rules of international legal practice as reflected in the model tax convention on income and on capital drawn up by the Organisation for Economic Cooperation and Development (OECD), in particular Article 23B thereof, it is not in dispute that Community law, in its current state and in a situation such as that at issue in the main proceedings, does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Community […] Consequently, if a Member State cannot rely on a bilateral convention in order to avoid the obligations imposed on it by the Treaty, the fact that both the Member State in which the dividends are paid and the Member State in which the shareholder resides are liable to tax those dividends does not mean that the Member State of residence is obliged, under Community law, to prevent the disadvantages which could arise from the exercise of competence thus attributed by the two Member States*").

can be seen as a step forward, losses are still largely isolated amongst Member States, as a consequence of the implementation of a tax model based on "territoriality as a principle". The effectiveness of the Court of Justice's approach cannot but suffer certain limits, which demonstrates the need for a legislative solution based on EU secondary law.

It is undisputable that the lack of an effective cross-border loss relief constitutes an obstacle to the cross-border activities of European enterprises and, therefore, to the exercise of fundamental Treaty freedoms and to the functioning of the Internal Market. It is, however, equally undisputable that the criterion that the Court of Justice came up with to solve the problem, i.e. the "final losses argument", cannot be accepted as a suitable solution to the issue, since it creates uncertainty as it is considerably vague.

A common consolidated corporate tax base, once finally enacted, could actually provide for a balanced regime with regard to the deduction of final losses, since such losses would be allocated and deducted in accordance with the way profits are taxed[856].

If it is to be accepted that EU-level harmonisation at least of the tax bases for the assessment, such rules would, according to the Court of Justice's case law as described in the second chapter of this study, need to take into account evaluations based on an EU-based "ability-to-pay principle", which would need to be implemented on a truly European level to the entire Internal Market, i.e. to all cross-border situations[857]. In order to do so, however, an EU cross-border ability-to-pay principle needs to be "created" first, with the necessary establishment of which should be the purposes of such a "constitutional" principle applied at the EU level.

It is true, however, that both the proposed interventions (a EU-level double taxation conventions and a EU provision on cross-border loss relief) would necessarily imply an underlying decision on which between the Member State of source and the Member State of residence would have to have priority to tax a certain item of transnational income. In other terms, the envisaged solutions could not *per se* allow the EU legislature to bypass the problem of which (if any) of the two traditional tax models can be considered as befitting the functioning of the Internal Market. Once again, then, we cannot but go back to the need of a legislative choice at EU level on the point

If, from a perspective that some (perhaps not being entirely wrong) define as utopic, we go back to the idea of an EU-level legislative intervention aiming at an integrated model for taxation across the entire Internal Market territory - provided,

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[856] Monsenego, J., *Taxation of foreign business income within the European Internal Market*, cited above, 452.
[857] Cerioni, L., *The never-ending issue of cross-border loss compensation within the EU*, cited above, 275.

however, that the current status of the division of competences established by the Treaties does not seem to provide the necessary basis for a hypothetical intervention - then it is certainly legitimate to wonder whether residence-based taxation can still be considered as appropriate in order to deal with the new fiscal issues related to cross-border transactions or a major change in the structure of national tax systems should be considered within the European Union Internal Market.

Originally, stronger taxing powers on the part of the source state were considered, in the EU context, as an obstacle to integration. However, since the Ruding Report, scholars have started to consider the possibility of a return to a purely territorial system, or at least of a strengthening of the taxing powers of the source state, as a chance to solve at least some of the problems of compatibility between domestic tax provisions and EU law, granting equal treatment to taxpayers and mirroring their effective situations, regardless of where they reside.

More in detail, three main proposals have been voiced for the purpose of strengthening taxation in the source country in the European Union, i.e. increasing withholding taxes at source with residual taxation in the residence Member State, exemption with progression and full allocation of taxing powers to the source Member State[858].

The first proposal (increasing withholding taxes and maintaining residual taxing powers in the Member State of residence) mirrors the position traditionally supported by capital importing countries and by the United Nations Model Convention: source states would be granted the right to levy higher withholding taxes both on residents and non-residents and, then, both residents and non-residents would be granted the right to take into account the taxes paid by withholding taxes in their respective country of residence.

It should be noted, however, that, whereas, as highlighted in the first chapter of the present research, the existing network of double taxation conventions already allocates a certain degree of taxing powers to the source state with respect, for example, to real estate located therein or to business income accrued through a permanent establishment, on the other hand, current EU secondary law on business taxation (e.g., the Parent-Subsidiary Directive and the Interest and Royalty Directive), as it has been shown in the third chapter, goes in the exact opposite direction, expressly prohibiting taxation at source and the levying of withholding taxes.

According to the second proposal, taxing powers should be allocated to the Member State of source, while the Member State of residence may take into account

[858] Pistone, P., *The impact of Community law on tax treaties. Issues and solutions*, cited above, 201.

foreign-source income in the overall income earned by the taxpayer only for the purpose of ensuring progressivity of taxation through the application of the proper tax rate, thus complying with the ability-to-pay principle. The same problems highlighted above with regards to the first solution apply, however, also with regards to the second proposal and certainly the solution could not be fully implemented until tax treaties are correspondingly amended, especially by countries adopting the credit method.

The third proposal would lead to the implementation of strictly territorial tax regimes, with Member States limiting the exercise of their taxing powers only on income accrued within their respective territories, regardless of the fact that taxpayers are residents or non-residents.

It could be argued that this solution would indeed provide for the highest possible degree of tax neutrality in the context of the European Union and within the Internal Market. However, this option encounters all the limits and challenges that have been analysed in the previous chapter, first of all the problem of defining the "source" of the income, since the source country may not necessarily coincide with the country where the income has its origin or is produced[859].

Moreover, another problem with this option would be constituted by the need for Member States to comply with the "*Schumacker* doctrine": if we suppose that an individual derives income from several Member States, each of them could levy its taxes on the income accrued within its territory, but then the problem arises as to where personal allowances should be granted. The issue, however, would be confined to the context of personal taxation, i.e. taxation of individuals with cross-border income, since corporations and other juridical persons are, of course, not allowed to deduct personal allowances from their income, given that they do not incur any "personal" expenditure: with regards to corporations, therefore, the source Member State could theoretically tax only the income produced or originated from an activity located in its territory and allow the deduction of expenditure effectively connected with the production of such income or expenditure suffered in its territory.

A possible way further could, therefore, be represented by the establishment of a system entailing the allocation of taxing powers amongst Member States on the ground of "objectively territorial" tax criteria across the Internal Market (source taxation), with regard only to corporate income taxation, with the necessary Treaty base to enact such legislation being the protection of the purpose of attaining an effective integration of the

[859] Kemmeren, E.C.C.M., *Origin-based double tax conventions and import neutrality*, in Rivista di Diritto Tributario Internazionale, 2001, 2, 103; Mason, R., *Tax discrimination and capital neutrality*, cited above, 126; Pistone, P., *The impact of Community law on tax treaties. Issues and solutions*, cited above, 203.

Internal Market and of the Member States' fiscal interest, also from an anti-avoidance perspective.

Such a model would allow overcoming the main problem concerning the establishment of a common corporate consolidated tax base and the difficulties of reaching an agreement on the topic, i.e. the disagreement on how to allocate the financial resources raised through corporate taxation. This hypothetical tax system would also establish the basis for a future, perhaps utopic, European Union corporate tax, the revenue of which would constitute one of the EU's own resources, finally providing the European Union a feasible leg to stand on when dealing with direct taxation.

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