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# An EC without withholding taxes?

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The role of tax treaties in ECJ:s discrimination-  
assessment

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20 points

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# Summary

It seems like it can never be said enough times: *in order to uphold the objectives of the Internal Market, an equal treatment of resident and non-resident taxpayers have to be granted by the Member States*. As for the intricate field of direct taxation, it is still somewhat unclear exactly how this equal treatment looks. Consequently, it is also unclear how far the Member States can stretch the benevolence of the ECJ in finding arguments to protect the mere essence of their existence- their tax base.

One way of coping with the increasing pressure on company taxation that Globalisation has brought with it is imposing a withholding tax on dividends and payments for interests and royalty leaving a tax jurisdiction. In practice though, this defence-strategy has actually turned out to be rather offensive. The withholding tax renders for double taxation for non-residents and in the prolonging, it infringes our cherished free movement-rights.

In order to set things right, the Member States have relied on a web of DTC, aiming at allocating the right to tax in a way supposedly eliminating double taxation. Even though the promise of elimination is in some cases an empty one, as no state of residency will actually *reimburse* the foreign tax, which would be necessary to neutralise the double taxation at source of for example dividends, the question put up for this essay is what difference a tax treaty actually makes to the discrimination assessment. Is there any point at all for the Member States to strive towards neutralisation of discrimination through the employment of DTC:s, or does the ECJ refuse to see beyond the impact of the national legislation?

The answer is to be found in the recent judgments of the ECJ, namely - *Bouanich* and *Denkavit II*. From these judgments I, and many others with me, understand that the ECJ accepts Members States imposing a legislation discriminating non-residents, if this discrimination is soothed by a tax treaty. In other words, the discrimination assessment made by the Court has been extended to cover the gathered effects of all national legislations and tax treaties affecting a taxpayer.

To a certain extend does this give the Member States a possibility to maintain taxing at source. Situations that in practice can be neutralised by a DTC are withholding on interest, royalties and dividends to natural persons. In the case of company taxation though, it seems like withholding taxation is living on borrowed time.

# Preface

I would like to express my gratitude to my supervisor, Cécile Brokelind, for as well the inspiring and demanding lectures on EC Tax Law, which gave rise to my interest in this topic, as the help and input on this thesis.

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# Abbreviations

<b>AG</b>	Advocate General
<b>CIT</b>	Corporate Income Tax
<b>The Court /the ECJ</b>	The Court of Justice of the European Communities
<b>DTC</b>	Double taxation convention
<b>EC</b>	The European Community
<b>The EC Treaty</b>	The Treaty establishing the European Community
<b>EEA</b>	European Economic Area
<b>The EFTA-Court</b>	The Court of the European Free Trade Association
<b>EU</b>	European Union
<b>MC/Model</b>	The OECD Model Convention
<b>OECD</b>	Organisation for Economic Co-Operation and Development
<b>Prop</b>	<i>Proposition</i>

# 1 Introduction

Even though the forming of an Internal Market, consistent with the objectives of the EC-Treaty, is one of the most important projects undertaken by the European Community, the matter of direct taxation has, meeting the demands of the Member States, been left out in the EC-treaty. Consequently, the harmonization of direct taxes has a very small Treaty-basis to rely on, the general harmonization-provisions being the sole tools for such an undertaking. The harmonization possibilities are further narrowed down by several other securities kept by the Member States, such as the veto-right.<sup>1</sup> Consequently, the road to harmonization of direct taxation is a winding piece of distance, entailing for the concordance of all 27 Member States.

The ECJ has in countless judgments established, that although direct taxation falls within their competence, the Member States must none the less exercise this competence consistently with Community Law<sup>2</sup> and avoid any discrimination on grounds of nationality.<sup>3</sup> The same is true in respect of tax treaties concluded with third states. Even though Article 307 of the EC-Treaty provides that treaties signed before the entry into force or before the accession of newer Member States continue to apply even if they contain provisions incompatible with the Treaty, paragraph two of the article requires the Member States to “take all appropriate steps to eliminate the incompatibilities established”.

In the jumble of International Taxation two systems distinguishes themselves as the main source of the Clash of Legislations. It is the tension between the residence- and source taxation that can be disguised as the villain of the piece. The unlimited taxation, applied by the state on its residents, lays claim on the world-wide income of a taxable person. The reason behind being that not only are residents enjoying the social benefits of their home state and consequently should contribute according to their ability to pay, but also should one jurisdiction tax the “residual income”, not attributable to any specific state.<sup>4</sup>

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<sup>1</sup> Article 95 (1) in the Single European Act (Official Journal L 169 of 29 June 1987), which entails for decisions on the internal market to be taken by a qualified majority, is not applicable to tax matters.

<sup>2</sup> Case C-279/93 *Schumacker* [1995] ECR I-225, Case C-264/96 *ICI* [1998] ECR I-4695 and Case C-471/04 *Keller Holding* [2006] ECR I-2107.

<sup>3</sup> Case C-80/94 *Wielockx* [1995] ECR I-2493, Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651 and Joined Cases C-397/98 and C-410/98 *Metallgesellschaft and Others* [2001] ECR I-1727.

<sup>4</sup> Wattel/Terra “*European Tax Law*” Kluwer Law, 4th edition, 2005.

A state may as well tax non-resident persons, but only on the particular sources of income established within its territory. Traditionally have the source state had neither the information about other incomes, or the practical possibilities to widen its tax claims. The limited taxation is based on the thought that it is the country offering the earning-opportunity that is the state with the natural right to tax the income. It is from this idea that withholding taxation springs. Withholding tax is a tax levied by the source state in relation to dividends, interest- and royalty-payments made to or by a non-resident taxpayer. As the tax is imposed on already taxed profits, or in the interest and royalty-case, profits to be taxed, it inevitably entails for double taxation.<sup>5</sup>

A State has in two alternatives to choose from when aiming at soothing the discomfort that double taxation causes its companies. When applying the *Credit Method* the Member State of residence taxes a company on its worldwide income, giving the concern a possibility to credit the tax already paid in the source state, against its tax claim. This method is thought to prevent that taxation affects the companies decision whether to invest abroad, as it entails for *Capital Neutrality Export*. Proponents for this method highlight that independent of the tax rate in the state of investment, the concern is in the end affected only by the tax rules of the country of residence, giving each investment the same tax-predispositions. This is though only true as far as the subsidiary is placed in a state with a *lower* tax rate, as no country in practice actually *reimburses* tax paid to a foreign fisc. Moreover, opponents point out that the method is problematic when it comes to market competition, as players competing in the same market are affected by different tax rates.

In order to attain *Capital Neutrality Import* a State is to use the *Exemption Method*, simply exempting from its tax base the profits already taxed in another jurisdiction. This method is clearly better in terms of equal competition-opportunities for companies investing in foreign markets from high-tax countries. But, the system is sensitive to tax competition, giving companies the incentive of placing its activities in low-tax jurisdictions and even avoiding tax altogether through the engagement of tax havens.

As for today no proposal have been adopted, or any other pointer shown, which gives one of the methods preference over the other in an EC context. Oppositely, directives<sup>6</sup> coping with the matter of double taxation give the Member States the freedom to choose which method to employ.

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<sup>5</sup> Baker "Changing the Norm on Cross-Border Enforcement of Tax Debts" 30 Intertax 6-7 (2002) p. 216-218.

<sup>6</sup> For example Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

As for the elimination of double taxation, Article 293 of the EC Treaty explicitly gives the Member States the competence to eliminate, by the conclusion of Double Tax Conventions, the obstacle to the Internal Market that it stands for. This does of course not rule out other legislature means, such as directives or regulations, to be used in order to achieve a fair taxation on cross border investments.

The status of the tax treaties in national law varies, as the domestic law, constitution, the procedures incorporating the treaties and the view of the relation between national and international law varies.<sup>7</sup> For Community purposes though, it is clear that the EC-Treaty takes precedence over the conventions. Nevertheless, it is only recently that the ECJ has started to examine how the important question of how tax treaty provisions corresponding with Community Law actually stands. And it is those cases we will take a closer look at for the purpose of this thesis.

The present state of company taxation within the European Community can be simply understood as an ongoing tug of war. On one side we have the Member States, trying to secure their tax-base from erosion by imposing withholding tax on incomes leaving their jurisdiction, arguing that the negative effects of this are eased by DTC. On the other side are the cross-border investors; wishing to gain from the promised land of the Common Market not settling with what *might* even out discriminatory legislation in a broader context, demanding equal treatment in the actual state of source. And it is with this situation in mind we proceed with the examination of the question put up for this essay.

## 1.1 Subject and purpose

It has to a great extent been established that the levying of withholding tax is an obstacle to the free movement-rights. Nevertheless, the question still stands if there is a possibility for the Member States, through the appliance of a convention aiming at eliminating the double taxation, to keep their cherished protection of tax-base. I will examine how the ECJ has interpreted the role of DTC in the discrimination-assessment of taxpayers and if the outcome of the recent judgments in this area inevitably leads to the conclusion that the Era of Withholding Taxes has reached the bitter end.

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<sup>7</sup> Vogel "Klaus Vogel on Double Tax Conventions" 3<sup>rd</sup> edition Kluwer Law International, 1997.

## **1.2 Delimitation**

I have chosen to restrict this essay to not go deeper into the comparison of taxpayers, discrimination, and justification-grounds from the perspective of the national legislation, since I am making the assumption that the imposition of withholding taxes is indeed discriminatory. In order to demonstrate the extend of these disturbing effects, I will present the Directives covering some of the transactions and consequently – leaving many outside the scope. I will examine the construction of the DTC from the perspective that these are in general based on the OECD Model. The ECJ-judgments, covering the problem of withholding taxation and the impact of DTC in these, will be presented and analyzed in order to knit it all together.

## **1.3 Method and Material**

As my thesis deals with the dynamic field of Community-law, the most relevant source of information is the examination of ECJ case law and the interpretation of it made by scholars and practitioners. In order to analyze and compile the information I use the traditional legal method.

# Withholding taxes

The term “withholding tax” is actually not defined by the directives dealing with the elimination of it. Although it is used in international tax-literature to cover the deduction of tax at source for cross-border payments, it has no precise meaning. The basal explanation is that it is a tax on cross-border transaction, *withheld*, just as the name implies, in the country of origin. On interpreting the ECJ it is understood that the withholding is on dividends is any tax for which the chargeable event is the distribution by a company to its shareholders of any benefit that could be regarded as income from shares, and which is calculated on the basis of that distribution without the possibility to deduct losses from previous years. In the assessment the name, classification and whether the distributing company or the shareholder is the taxable person is not of significance. According to the Court “withholding tax” is a community law-term, to be interpreted autonomously and substantively.<sup>8</sup>

The tax is usually levied on dividends, interest payments and royalty payments and it is in many situations seen as the sole way to ensure a minimal tax base in the country of source. The Member States further claim to use the withholding tax as an only mean to hinder foreign investors to gain tax-planning opportunities.<sup>9</sup> Nevertheless, the withholding tax is creating a great deal of disturbance to the internal market, as it entails for excessive taxation and cumbersome administrative formalities for the companies involved in these kinds of transactions.<sup>10</sup>

Two categories of discrimination can be derived from the appliance of withholding taxes by the source state. The first is where a domestic taxpayer benefits from an exemption, reduced rate or refund on the withholding tax, while a non-resident taxpayer is denied such benefit. The other category is where both resident and non-resident taxpayers are subject to withholding taxation, but the resident ones can credit the paid withholding tax against their corporate income tax liability. The foreign taxpayers, not being subject to tax in the source-state, are not entitled to a corresponding credit.

Under certain circumstances the situation have been regulated by directives restricting the Member States possibilities to levy a withholding tax, in order to ensure cross-border investments an equal treatment to their domestic equivalences. It has to be kept in mind though, that the directives

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<sup>8</sup> For example the *Epson case* C-375/98 *Ministério Público, Fazenda Pública v. Epson Europe BV*, [2000] ECR I-4243 and Case C-294/99 *Athinaiki Zythopoiia AE v. Ellinko Dimosio* [2001] ECR I-6797.

<sup>9</sup> For example the Swedish legislators in Prop. 2002/05:146, p.12.

<sup>10</sup> Wattel/Terra *European Tax Law* Kluwer Law 4th edition, 2005.

addressing the problem only apply to strictly defined situations, namely those of company-groups with a qualified ownership. Nevertheless, dividends and royalty- and interest-payments can not be seen as phenomena intimately related to intra-group transactions. This kind of commerce is an important part of the trade also between parties falling outside the scope of the Directives and withholding taxation is therefore still imposing a great deal of disturbance to the Internal Market.

It has not always been clear to the Commission that the levying of withholding tax on cross-border situations is a thing of malicious art. During the first half of the year 1989, the Commission tried to launch a anti-tax avoidance scheme containing a common system of withholding tax on interest income.<sup>11</sup> The need for the proposal was derived from an increasing risk of avoidance or evasion from capital income tax, a result of the liberalization of capital movements. When EC-residents were allowed to transfer their savings into bank accounts in other Member State, the risk arose that the foreign interest rate would not be declared to the national tax authorities, and hence left untaxed. Therefore, held the Commission, an overall withholding tax of 15% should be levied at source. The Council though rejected the proposal later the same year.

Consequently, it should be understood that the levying of withholding taxes is an important instrument used by the countries to protect their tax-base, claim their right as the source-country and make sure that the increasing cross-border exchange does not result in an obfuscation of the tax authorities.

## 1.4 The Parent-Subsidiary Directive

It is clear that when a Member State is imposing a withholding tax on profits distributed to foreign owners, groups involved in cross-border investments run a significant risk of overtaxation. The company profits are first inflicted by a CIT and then, upon distribution, a withholding tax is levied on the dividends in the source state. Furthermore, the company groups run a risk of yet another tax being imposed in the home state of the receiving company. Insofar the situation is not regulated by a double-tax convention and the dividends are not exempt from taxation in the national legislation of the receiving state, the prerequisites for as well economical, as

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<sup>11</sup> Communication from the Commission to the Council “*Tax Measures to be Adopted by the Community in Connection with the Liberalization of Capital Movements*”, COM (89) 60 final, 8 February 1989. Includes: Proposal for a Council Directive on a Common System of Withholding Tax on Interest Income Proposal for a Council Directive of Amending Directive 77/799/EEC Concerning Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation and Value Added Tax

juridical double taxation, are clearly at hand. As for the situations that are covered by a DTC, a discrimination arises from the fact that foreign investors are still taxed twice on the same profit in the country of establishment.

With this situation in mind, and over 20 years of negotiations, the Council adopted the Parent-Subsidiary Directive in August 1990. The choice of using a directive instead of regulation, which would have a stronger legal value and guarantee a direct effect, is probably due to the limiting political situation dealt with in the EC. Consequently, the practical results of the provisions are by some seen as a disappointment in relation to the goals set up for the Directive.<sup>12</sup> Amendments to the directive was adopted in 2003<sup>13</sup>, the changes mainly aimed at widening the scope and improving the elimination of the double taxation-mechanism.<sup>14</sup>

It should be kept in mind that the withholding taxes on dividends usually were at a rate of 10 – 25 %, and the budgetary sacrifices made by the Member States when implementing the Directive are in some cases considerable. Hence, some implementation-versions, inconsistent with the objectives of the Directive, have seen the light of the day, being an attempt for the Member States to autonomously narrow down its appliance.<sup>15</sup>

The Directive entails for cross-border profit distributions, paid out of after-tax profit by a subsidiary resident in the EC to its EC-parent, to be exempt from withholding tax by the Member State of the subsidiary.<sup>16</sup> Furthermore, the dividend has to be free of double corporate taxation in the Member State of the parent company.<sup>17</sup> Consequently, the Member State of the receiving company must either refrain from taxing the income altogether, according to the exemption-method or, if it is taxed, a credit against the company's corporate income tax has to be given.

Using the credit method, the income is taxed, but the parent company can offset the tax paid by the subsidiary on the income that generated the dividend, against its corporate income tax. This method raises some issues as for the effects on the company's tax burden. Under circumstances where the tax in the state where it was initially paid is higher than in the receiving state, the Directive does not require for the receiving company state to

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<sup>12</sup> Brokelind "Implementeringen av moder-dotterbolagsdirektivet i några medlemsstater", Svensk Skattetidning, 2004.

<sup>13</sup> Council Directive 2003/123/EC.

<sup>14</sup> For further reading see C. Brokelind, "The Proposed Amendments to the Parent-Subsidiary Directive: Some progress?" *European Taxation* 10 (2003) p. 451.

<sup>15</sup> Brokelind "Implementeringen av moder-dotterbolagsdirektivet i några medlemsstater", Svensk Skattetidning, 2004.

<sup>16</sup> Article 4 of the Directive.

<sup>17</sup> Article 5 of the Directive.

refund any excess foreign tax. Even though the capital export in this way becomes neutral, the credit-method entails for different tax-situations for companies in the same Member State, depending on the state of residence of their subsidiary.

### 1.4.1 Applicability

The objectives of the Directive are indeed sought-after, but the scope of the companies getting to enjoy them are limited. The applicability is narrowed down by several conditions set up to be satisfied for the entitlement to the Directive benefits.

Primarily, the companies must be incorporated in one of the legal forms listed in the annex to the Directive<sup>18</sup>. Inspired by the *Ruding Report* from 1992<sup>19</sup> the Commission suggested the year after it came, that the Parent – Subsidiary Directive should include all undertakings subject to corporate tax, irrespective of its legal form.<sup>20</sup> Under the consultation procedure the following year, the European Parliament approved of the amendments.<sup>21</sup> However, the proposal was withdrawn as asymmetries in the commercial law governing the legal forms and the different tax arrangements applicable to them caused considerable problems.<sup>22</sup> Instead, the already mentioned amending directive was adopted by the Council in 2003. The broadening of the Directive regards, in the first place *Societas Europaea*<sup>23</sup>, certain transparent companies and specific cases involving permanent establishments.

The fiscal residence of the corporation has to be within the European Community.<sup>24</sup> This disqualifies not only companies resident outside the Community but as well those within the Community, but of dual fiscal residence. Furthermore, the companies have to be subject to a corporate income tax from the list in Article 2(c) or to a tax that may substitute any of those taxes. No possibility of exemption or option concerning the taxes can be at hand in order for the companies to qualify for the benefits. On the up side, there is nothing Article 2 indicating that the criteria have to have to be fulfilled in the same tax jurisdiction, opening up for a wide range of possibilities when it comes to cross-border establishments.

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<sup>18</sup> Article 2 (a).

<sup>19</sup> Report of the Committee on Company Taxation, “Ruding Report” Brussels 1992.

<sup>20</sup> Proposal COM (93) 293 final to amend Directive 90/435/EEC, of 23 July 1990, submitted to the Council on 26 July 1993, O.J. No. C225/5 of 20 August 1993, withdrawn and replaced in 2003.

<sup>21</sup> EP 1994-1995, minutes of the sitting of 19 April 1995, p. 67-71, O.J. No. C 128 of 9 May 1994, p. 91.

<sup>22</sup> Wattel/Terra *European Tax Law* Kluwer Law 4th edition, 2005.

<sup>23</sup> Directives Annex, letter (p).

<sup>24</sup> Article 2 (b).

As profit-distributions are naturally connected with ownership, the directive sets, in its 3<sup>rd</sup> Article-first section, up a qualifying holding for the companies to enjoy the benefits. Following the recommendations in the *Ruding Report*, reductions are being stipulated in the amending directive to finally constitute a 10% hold in the capital, as they are now 25%. It is important to take notice that the minimum holding requirements are addressing the Member States and the situations in which they are obliged to grant parent-subsidiary-status. There is no obstacle to widening the definition by the Member States themselves by lowering the holding requirement, Article 3(1)(a), or bilaterally agree on using the voting rights instead of the shareholding as a qualifying measurement, Art 3(2).

In order to assure that the rules are not abused, the Directive allows for Member States to deny Parent-Subsidiary status companies not fulfilling the a minimum holding period of two years, Art 3(2). It is at the Member States discretion to lower this period or even remove it. In the *Denkavit and others* – case<sup>25</sup>, the much discussed issue of whether the minimum-holding-period can be demanded to be fulfilled at the time of the granting of the status, the Court made it clear that no such possibility for demand is at hand.

## 1.5 The Interest and Royalty Directive

The withholding tax is less disquieting when affecting royalty and interest payments. Unlike dividends, these transactions impose an actual cost for the paying company and are consequently deductible from the taxable profit. Interest and royalty- payments are typically well attended to in double tax-conventions, the excessive tax most often reduced, or waived completely.

Nevertheless, the withholding taxes still render for over-taxation and cumbersome administrative formalities. First of all, not all Member States-relations are covered by double-tax conventions and it is, as obvious from the topic of this thesis, not clear if such solution is sufficient for the legislation to not be discriminatory.

For the states covered by a convention, it does not provide solutions when it comes to triangular-situations, i.e. payments made to or by a branch situated in another Member State.<sup>26</sup> Moreover, if the double taxation is actually

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<sup>25</sup> Joined Cases C-283/94, C-291/94 and C-292/94 *Denkavit Internationaal BV, VITIC Amsterdam BV and Voormeer BV v. Bundesamt für Finanzen*, of 17 October 1996 [1996] ECR I-5063.

<sup>26</sup> Wattel/Terra “*European Tax Law*” Kluwer Law, 4th edition, 2005.

eliminated by the treaty, it is in practice most often made by a recovery of the tax after an initial withholding, a process calling for a cumbersome and time-consuming administrative activity, causing cash-flow- and interest losses.<sup>27</sup>

In order to deal with the problems presented above, the first proposal for the Interest and Royalty-Directive was launched by the Commission in 1991<sup>28</sup>. The Ruding Report pointed the year after out the proposal as one of the priorities for the maintenance-projects of the Internal Market, but it was nevertheless withdrawn in 1994 due to disagreement within the Council. A new proposal for the Directive was launched in 1998<sup>29</sup> and adopted in 2003 as a part of the “package of three” to tackle harmful tax competition<sup>30</sup>. When adopting the Interest and Royalty Directive it was anticipated to render few problems in the practical appliance since it was designed taking up the already working technique of the Parent-Subsidiary Directive. In retrospective, it turned out to not be as efficient as hoped for and authors commenting on the Directive and its two amendments point out several problems appearing after its implementation.<sup>31</sup>

### 1.5.1 Applicability

The Directive requires for the State of the paying company to exempt payments in relation to royalty or interest made to an associated company in another Member State, if that company is the beneficial owner of the right, whether the tax is levied by withholding at source or by assessment.

The Directive in principle follows the OECD’s Model Convention and Article 11(3) as for the definition of the term “interest”, while the definition of the term “royalty” is an improved version of the one in the Convention’s Article 12(2). Consequently, the interest is shortly put an “income from debt-claims of every kind”<sup>32</sup> and the royalty is defined as a payment for the

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<sup>27</sup> For further discussion see Boekhorst “*The Need for Elimination of Withholding Taxes in a Common Market*” European Taxation, May, 1995, Lars-Erik Wenehed “*Withholding Taxes*” 35 European Taxation 2, 1995 and Robert Boon “*To Withhold or Not Withhold, That is the Question*”, 34 European Taxation 9, 1994.

<sup>28</sup> COM (90) 571 final, OJ C 53, 28 February 1991, p. 26.

<sup>29</sup> COM (1998) 67 final, OJ C 123, 22 April 1998, p. 9.

<sup>30</sup> Communication by the Commission in October 1997 “Towards tax co-ordination in the European Union” COM (97)495 involving a non-binding Code of Conduct for Business Taxation to curb excessive tax competition, measures to eliminate distortions in effective taxation of capital income, especially interest on savings and measures to eliminate withholding taxes on cross-border payments of interest and royalties between companies.

<sup>31</sup> Eicker & Aramini “*Overview on the recent developments of the EC Directive on Withholding Taxes on Royalty and Interest Payments*” EC Tax Review 2004 (3).

<sup>32</sup> Article 2(a) of the Directive.

right to use copyrights, trademark, patents, designs, know-how, software and industrial, commercial and scientific equipment, etc.<sup>33</sup>

The Ruding Committees recommendations to extend of the scope of the Directive to cover all interest and royalty payments between enterprises irrespective of legal form and affiliation have not been followed. Neither has the 1998 draft, wherein the reference to a static list of qualifying companies was abandoned and a more dynamic application of the Directive was promoted. In the finally adopted version, several kinds of legal forms fall outside the scope of the Directive. The list of approved legal forms annexed to the directive does for example not cover *European Companies* and *European Cooperative Societies*, a relevant difference in relation to the Parent and Subsidiary-directive. This issue is at present pending as an amendment proposal from the Commission, but has at this point not yet been adopted.<sup>34</sup>

Another requirement set up by the directive is the one of *beneficial ownership* in Article 1(4). The definition of the term “beneficial owner” is one of the most discussed in international tax.<sup>35</sup> Without going deeper into the semantic discussion, the meaning of the term can be simply put as that the company receiving the payment has to do it for its *own benefit* and not as an intermediary. The provision is premeditated to curb artificial corporate structures set up only in order to benefit from the directive and it is thereby only those companies that are excluded from the application of the directive.

Article 4 gives the Member States the possibility to deny the application of the Directive in certain specific cases. In the memorandum to the 1998 Draft it is stated that the provision provides the Member States with a tool to counteract abuse in those cases where the interests paid is disguised profit distribution or a return on the provision of equity.<sup>36</sup> As for the recharacterization of the interest payments to dividends, it is unclear whether the distributions should fall under the Parent - Subsidiary Directive as was stated in the 1998 Draft. In the Drafts Article 4 it was explicitly stated that if the other conditions are met, the distributions should fall under the Parent-Subsidiary Directive. The fact that the clarification was omitted in the final version of the Interest and Royalty Directive gives rise to a discussion whether the provision is still valid<sup>37</sup>

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<sup>33</sup> Article 2(b).

<sup>34</sup> Proposal for a Council Directive amending Directive 2003/49/EC, COM (2003) 841 Final.

<sup>35</sup> According to the IBFD's *International Tax Glossary* “it is not clear whether there is an established consensus among tax authorities as to the precise meaning of the term...”

<sup>36</sup> Explanatory Memorandum on Article 4 of the 1998 draft Directive.

<sup>37</sup> Distaso and Russo, “The EC Interest and Royalty Directive – A Comment” *European Taxation*, April (2004) p. 150, Vaninstendael “*The ECJ at the Crossroads: Balancing Tax*

# Double Tax Conventions

The issue of double taxation, as not only being a Community problem, has been approached by a worldwide network of bilateral tax treaties in general based on the OECD Model Tax Convention. It is clear that OECD Model had had great influence on the negotiations, application and interpretation of Tax Treaties for over 40 years<sup>38</sup>, nevertheless does the Model leave significant possibilities for the States to bilaterally decide on the contents of the conventions and therefore do the practical effects of the treaties vary.<sup>39</sup> The function of the conventions are nevertheless the same, to allocate the taxing rights between the resident and source states and “to clarify, standardize and confirm the fiscal situation of tax payers” through the application of common solutions to cross-border situations by all countries.<sup>40</sup>

The Model does indeed tend to the non-discrimination of non-residents, but not to the same extent that the EC-Treaty. Article 24 in the MC contains a provision prohibiting discrimination based on the nationality of the taxpayer or of its shareholders, but it does not consider residents and non-residents to be in the same position for tax-purposes. As stated in Article 24 (1):

“Nationals of a Contracting State shall not be subjected in other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected.”

International tax law is thus only prohibiting discrimination based on nationality and not on residence, consequently; cross-border investments are under the MC only protected from *direct* discrimination. This is a deviation from the EC-provisions, which regards the difference in treatment between residents and non-residents as *indirect discrimination*, based on the fact that the non-residency most often coincides with non-nationality.<sup>41</sup>

The practical application of the MC is found in Articles 6 to 22, the distributive rules, laying down the regulations for attributing the right to tax

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*Sovereignty against the Imperatives of the Single Market*” European Taxation, Sept 2006, p. 41.

<sup>38</sup> Hilling ”*Free Movement and Tax Treaties in the Internal Market*” Iustus Förlag, 2005 p. 55.

<sup>39</sup> Van Raad, Comment: “*The Meaning of Nondiscrimination*” in Vogel (ed), “*Taxation of cross-border Income, harmonization and, tax neutrality under European Community law*” Kluwer Law, 1994, p. 46.

<sup>40</sup> OECD Model, Introduction OECD Commentaries, Paragraphs 2-3.

<sup>41</sup> For example as stated in the Case C – 175/88 *Klaus Biehl v Administration des contributions du grand-duché de Luxembourg* [1990] ECR I – 1779.

in respect of different types of income. The distributive rules do in principle not deal with the determination of taxable income, deductions or tax-rates, leaving these questions to domestic legislation of the contracting states.<sup>42</sup> Double taxation is dealt with either by dividing the taxation rights between contracting states or, more commonly, by assigning it primary or exclusively to one of them, usually the one of residence.

The right to tax dividends and interest is by the MC divided between the contracting states. In Article 10 the source states right to tax dividends is restricted through a limit on the level of withholding to 15 %. For inter-company transactions, that is involving groups where the ownership exceeds 25% of the subsidiary, the maximum withholding is limited to 5 %, in order to facilitate direct investments abroad and reduce the multiple taxation of intra-group profit distributions.<sup>43</sup> Article 11 deals with the taxation of interest-payments. Even though the taxation is restricted for the source state to 10% of the gross amount of the interest, the states are keeping a great deal of discretion, being free to impose their domestic law on these 10 %. The MC is often deviated from by the industrial countries in the matter of allocating the taxing rights for interest. Instead of the prescribed division between legislations, an exclusive taxing right for the recipient's state of residence is used.<sup>44</sup> In order to avoid double taxation, the MC demands in relation to both dividends and interest for the state of residence to give a credit for tax levied in the source country. This demand is definite, even in cases where the residence-state is normally using the exemption method.<sup>45</sup> The taxation right-situation for royalty differs, as the MC gives the residence-state an exclusive right to tax royalty income. Nevertheless, have many states chosen to use a shared taxing right solution in relation to these kind of transactions.<sup>46</sup>

When assessing the legal status of the DTC, a distinction that could be relevant is the way the convention is transposed into national law. In this matter, there is a difference between nations with a monistic view and those with a dualistic one. While the first approach sees both the international and internal law as parts of one legal order, the second considers the internal and international law as two separate systems, existing independently from each other.<sup>47</sup> Under normal circumstances, when the tax treaty has been

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<sup>42</sup> Paragraph 38 of the OECD Commentaries on Article 23A and 23B.

<sup>43</sup> Article 10 (2) (a), in the OECD Commentaries to Article 10, paragraph 15, the contracting states are allowed to use the voting rights instead of capital.

<sup>44</sup> Article 11 (2) Vogel "*Klaus Vogel on Double Tax Conventions*" 3<sup>rd</sup> edition, Kluwer Law International, 1997.

<sup>45</sup> Articles 23 A and 23 B, OECD Model.

<sup>46</sup> Article 12. Hilling "*Free Movement and Tax Treaties in the Internal Market*" Iustus Förlag, 2005 p. 59.

<sup>47</sup> Malanczuk "*Akehurst's Modern Introduction to International Law*", 7<sup>th</sup> editon, Routledge, 1997, p.63.

transposed into national law, it prevails over national law in the case of a conflict.<sup>48</sup>

The relation between national, international and Community-law is of a complicated kind. Article 5 of the EC-Treaty obliges the Member States to avoid concluding treaties with provisions violating the EC-law. To which extend conventions are invalid insofar they do violate Community Law is a subject of discussion. The general rule is that if treaties between Member States contravene Community law, Community law will prevail.<sup>49</sup> Some authors go further and point out that all treaties a Member States conclude have to be in accordance with substantive, primary and secondary Community law.<sup>50</sup>

In conclusion, the web of double tax conventions based on the OECD Model is primarily aimed at allocating the taxing rights between contracting states in order to facilitate cross-border investments, and only to a certain extend do they guard the equal treatment such investments in relation to the national ones. Following this, the demands put up by double tax conventions can still render for discrimination from the EC-perspective. We will now proceed to examine the ECJ-case law, where DTC based on the specific rules of the OECD Model for allocation of taxing right are evaluated as for their ability to eliminate discrimination.

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<sup>48</sup> Eicker “*Tax Treaties and EC Law: Comment on the Gilly Case*” European Taxation, October 1998.

<sup>49</sup> Vogel *Klaus Vogel on Double Taxation Convention*, third edition, Munich, 1997.

<sup>50</sup> Scherer “*Doppelbesteuerung und Europäisches Gemeinschaftsrecht*” Munich, 1995.

# The ECJ vs Tax Treaties.

## 1.6 First round

The principle of the supremacy of EC-Law over the national legislations of the Member States, was established very early in the landmark decisions, *Van Gend en Loos*<sup>51</sup> and *Cost/Enel*<sup>52</sup>. The legal relation between the demands of the Internal Market and the provisions set up by a DTC on the other hand, is still of more complicated character.

It was not until the *Avoir Fiscal*<sup>53</sup>-decision in 1986 that the relationship between tax treaties and EC Law came under the scrutiny of the ECJ. The French Government attempted to justify the refusal of a benefit to a non-resident company, with the argument that the same benefit would not have been granted the French company in the other contracting state due to the lack of reciprocity in the tax treaty. The ECJ confirmed in its judgment that the rights conferred in Article 52 are unconditional and a Member States can not make the granting of the right subject to the contents of a DTC. The *Avoir Fiscal* became the first decision in which the ECJ confirmed that directly effective provisions of primary Community law are valid irrespective of tax treaties between the Member States.

Although there had been some cases, as the *Avoir Fiscal* mentioned above, where tax treaty provisions had a certain impact on the examined situation, the focus had always been on the compatibility of the national provision with the free movement law, and it remained like that until the *Gilly*-case came, in 1998.<sup>54</sup>

Mrs Gilly, a German woman, had acquired French nationality through marriage. She was resident in France, but had continued her economic activities in Germany. The French-German tax convention ascribed the taxation rights for her income to the source state, Germany. France, nevertheless, as the state of residence, had the secondary right to tax her earnings. The convention included a double-taxation relief mechanism formed as a credit in France for the tax paid in Germany. In the *Gilly*-case the German tax exceeded the French tax claims. The reason behind the high tax burden was the German tax-splitting system, which was denied her as a

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<sup>51</sup> Case 26/62 *NV Algemene Transport- en Expeditie Onderneming van Geng & Loos v. Nederlandse Financierverwalting* [1963] ECR at 1.

<sup>52</sup> Case 6/64 *Flaminio Costa v. ENEL* [1964] ECR at 1251.

<sup>53</sup> Case C- 270/83 *Commission v French Republic* [1986] ECR at 273.

<sup>54</sup> Case C- 336/96 *Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin* [1998] ECR I – 2793.

non-resident.<sup>55</sup> The Gilly's brought a claim against the French tax authorities, arguing that the application of the tax convention between France and Germany led to unjustified, discriminatory and excessive taxation, incompatible with Article 12, 39 and 293 of the EC-Treaty.

The *Tribunal Administratif de Strasbourg* wanted to find out whether the provisions of a tax treaty have to be in accordance with EC-Law, if Article 293 is directly applicable for the benefit of the taxpayer and if the situation at hand actually renders for a discrimination.

In its judgement, the Court did not explicitly state that a tax treaty have to agree with EC law. The mere fact though, that the ECJ examined the provisions in the light of the EC Treaty, implicitly holds that such a requirement exist. As for the direct applicability of Article 293, the theory was rejected by the Court, holding that the Article is only created in order to lay down the agenda for issues the Member States should solve between themselves.

The ECJ further confirmed the elimination of double taxation as an objective of the EC-treaty. It continued with establishing that since the only harmonisation-process undertaken by the EC up until this point was the adoption of the *Arbitration Convention*<sup>56</sup>, it is at the discretion of the Member States to determine the criterion for taxation and to conclude conventions in order to eliminate double taxation.<sup>57</sup> This, continued the Court, gives the Member States the freedom to choose connecting factors when allocating the right to taxation. The DTC between Member States could reasonably be based on the OECD Model and the used source-state principle. The ECJ held that the source state-principle, relevant in the present case, is widely employed and can be seen as internationally accepted. In relation to this, the Court concluded that the criterion of nationality in determining the allocation of fiscal jurisdiction, as stated in the double tax convention in question, was not of such character that it constituted discrimination prohibited under Article 48 (now Article 39) of the EC-Treaty.

The conclusion of the Court has been met with as well approval, as some scepticism, in the tax law world. According to some authors, it seems to be deviating from earlier case-law, as well in the line of thoughts, for instance

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<sup>55</sup> Vanistendael, *Case C-336/96 Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin, Judgement of the Court of 12 May 1998. Full Court* .[1998]ECR I-2793 *Common Market Law Review*, 37, 2000, page 168.

<sup>56</sup> Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises 90/425/EEC, OJ L 225 of 20 August 1990, at. 10.

<sup>57</sup> It should be noticed that the lack of harmonization had previously been dismissed by the Court as a justification ground for discriminatory tax treatment, in the *Avoir Fiscal Case*, Case C – 270/83 *Commission v France* [1986] ECR 273.

discussing the *objectives* of the provisions and not mentioning the *effects* of it, as customary in this kind of cases and in not establishing if the non-resident taxpayer was in a objectively comparable situation.<sup>58</sup> In relation to the outcome, a reference can be made to the *Futura*-case<sup>59</sup>, from which it could be understood that the Court has actually established that in some cases, where national measures are discriminatory in relation to nationality, they could still be in conformity with the free movement-right if they correspond with the essential principles of another field of law.<sup>60</sup> Others found that Mrs Gillys claim, as it was put forward, gave the Court no other choice than to deny it. This, due to the interpretation that a discrimination did actually not arise in France, but it was the denial of the splitting-system in Germany that rendered for the unjust treatment.<sup>61</sup>

The critics of the judgment have drawn the conclusion that the Court gave way for a compromise in favour of the OECD MC and the internationally accepted tax-measures. These interpreters point out that if the Courts would have chosen to dismiss the provisions as discriminatory, this would have had great negative impact on the situation of the international trade. If the rules on allocating the power to tax would have been rejected by the ECJ, it would not only have had impact on the convention at hand but obviously affected the whole network of bilateral treaties based on the MC, running the situation of international tax law into chaos.<sup>62</sup>

To derive from the *Gilly*-case that the Member States are protected from the long arm of the EC-law by relying on the international practice of the OECD MC, would be to read in too much into the judgement. For example in a following case, *Saint-Gobain*<sup>63</sup> the status of permanent establishment was discussed, and the ECJ rejected the practice of the tax treaty. Doctrine has implied that the consequences of dismissing the part of the MC relevant in the *Saint-Gobain* were not as far-reaching and dangerous to the international trade as they would have been in the *Gilly*-case, and consequently the ECJ took courage and rejected the provisions.<sup>64</sup>

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<sup>58</sup> Hilling "Free Movement and Tax Treaties in the Internal Market" Iustus Förlag, 2005 p. 254.

<sup>59</sup> Case C- 250-95 *Futura Participations SA & Singer v Administration des Contributions (Luxembourg)*, Judgement of 15 May 1997 [1997] ECR I-25471

<sup>60</sup> Hatzopoulos, "Case C- 250-95 *Futura Participations SA & Singer v Administration des Contributions (Luxembourg)*, Judgement of 15 May 1997 [1997] ECR I-25471, Common Market Law Review 35, 1998, p. 502.

<sup>61</sup> Eicker "Tax Treaties and EC Law: Comment on the Gilly Case" European Taxation, October 1998.

<sup>62</sup> Wattel/Terra *European Tax Law* Kluwer Law 4th edition, 2005.

<sup>63</sup> Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.

<sup>64</sup> Hilling "Free Movement and Tax Treaties in the Internal Market" Iustus Förlag, 2005 p. 263.

## 1.7 The recent developments

### 1.7.1 Bouanich

The *Bouanich*-case<sup>65</sup> involved a woman, non-resident in Sweden, the Swedish rules on repurchase of shares in connection with the reduction in share capital and in continuation of this, the applicability of the Swedish-Franco double tax convention.

The Swedish legislation was at the time making a difference between resident shareholders, for whom the repurchase was taxed as a capital gain at 30%, entitling to deduction for the acquisition-costs, and non-residents which had to receive the payments as dividends, inflicted with withholding tax of 30%, without the possibility to any deductions.

Fortunately, the situation for non-resident shareholders was a bit soothed by the Swedish-Franco double tax convention. The treaty primary ascribed the taxing right for dividends to the state of residence, in this case France. Further, it allowed for the source state to withhold a tax not exceeding 15 % of the value of the dividends. In the commentaries to the OECD MC Article 10, it was found that a deduction for the nominal value of the shares should be permitted in the case of repurchase.

Ms Bouanich, a woman resident in France, had sold back a great amount of shares to a Swedish company, and was in relation to this taxed with a 15 % withholding tax on the whole amount. After a claim from her, the Swedish tax authorities reimbursed the part of the tax levied on the nominal value, in order to meet the commentaries to the MC. Ms Bouanich was not satisfied, and pled to the *Swedish Administrative Court of Appeal*, with a claim to regain the whole amount of the tax, arguing that the source taxation constituted a restriction on the free movement of capital.

In relation to this, the Swedish legislation was changed to allow also non-residents to take acquisition-cost into consideration when determining the taxable amount. Nevertheless, the discrepancy between resident and non-resident shareholders continued in the aspect that the payments for the repurchased shares were still classified as dividends and inflicted by a withholding tax when received by non-resident shareholders.

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<sup>65</sup> Case C-265/05 *Margaretha Bouanich v. Skatteverket* [2006] ECR I-0000.

The questions put forward to the ECJ by the Swedish Court were consequently in view of the outdated Swedish legislation; nevertheless did the Advocate General and ECJ deliver their opinion and judgment.

The first question dealt with whether the difference in tax treatment between residents and non-residents constituted a discrimination, contrary to Article 56 in the EC-treaty. Primary the Advocate General, Ms Kokott, contained that the transaction do fall within Article 56 of the EC-Treaty and went on to discussing whether the Swedish legislation rendered for a discrimination in relation to the avowed article.

She concluded that the Swedish legislation leads to a “*difference in treatment as between operators on financial markets* on account of their place of residence”, and in the prolonging, a discrimination and a discouragement for foreign investors. Further, the AG developed a long discussion on possible justification-grounds, of which she found that none could apply to the discrimination at hand. The view of AG Kokott was upheld by the ECJ, without a further development of her standpoint.

The second question was whether the application of a DTC, providing for a lower rate of taxation for non-residents and the possibility to deduct the nominal value of the shares, would eliminate the discrimination that the national law rendered for.

Advocate General Kokott divided this question into two subsections. The first dealing with the relevance of DTC:s when assessing the conformity of the internal provisions with EC-Law and the second, whether the treaty at hand eliminates the discriminatory status of the national legislation.

The initial discussion considered to which extend a Member States can rely on its DTC when accounting for the conformity of its national legislation with EC-law. The AG and the Court dismissed Ms Bouanich’s claim that a tax treaty is irrelevant for the assessment. Ms Bouanich view in this question had been supported by the Commission, which referred to earlier ECJ-judgements such as *Avoir Fiscal*<sup>66</sup> and *Saint-Gobain*<sup>67</sup>. From these the Commission had drawn the conclusion that the compliance of national provisions with the EC-law is independent of, and overriding to, tax treaties. In conclusion, a Member State could not, in the opinion of Ms Bouanich and the Commission, protect itself from the necessity of implementing non-discriminatory legislation by relying on a tax treaty.

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<sup>66</sup>Case C- 270/83 *Commission v French Republic* [1986] ECR at 273.

<sup>67</sup> Case C-307/97 *Compagnie de Saint-Gobain, Zweigeneiderlassung Deutschland v Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.

This line of reasoning did, as stated above, not convince, neither Ms Kokott nor the ECJ. Ms Kokott pointed out that the abolition of double taxation is stated as an objective in the EC-Treaty and that the Member States are free to conclude DTC in order to fulfil this purpose. When doing so, the mere allocation of taxing-rights through connecting factors does not render for discrimination. Nevertheless, she continued, does the DTC and the effects of it have to be in compliance with Community rules.

The AG concluded that since the convention applicable to the situation is a part of the Swedish internal law, due to the strict dualistic system according to which the implemented tax treaties are given the same value as national law, it is in no way irrelevant.<sup>68</sup> When comparing the case to *Avoir Fiscal*, she points out that in the previous case the discrimination was caused by the lack of tax treaty dealing with the issues at hand, while in this case the question was whether a tax treaty actually eliminates the discrimination.

The conclusions of AG Kokott was that not only are tax treaties a relevant part of the estimation if a national provision renders for discrimination in relation to EC-Law, but that the particular case has to be examined by the national court, weighing in all the conditions at hand. In other words, it was now up to the Swedish court to compare the situation of the non-resident share-holder with a resident equivalence. The ECJ confirmed the standpoint of Ms Kokott, without further developing her arguments.

The *Bouanich*-judgment caused some consternation in the tax-law world. Articles with expressive titles like “Towards the end of withholding taxes?”<sup>69</sup> interpreted the outcome as overthrowing the *Avoir Fiscal*-ruling. The author of the article seems to understand *Avoir Fiscal* as that the ECJ did at the time not accept that tax treaties could absolve the non-compatibility of national legislation with the EC-law. According to me, such interpretation was rejected by AG Kokott in her opinion to *Bouanich*, in which she correctly pointed out the difference between *Avoir Fiscal* and this case, namely the actual non-existence of a DTC in the previous one. Consequently, one can not say that a *new principle* is now applying to the *same situation*.

Another author, Ms Brokelind, sees the newly arisen principles of the *Bouanich*-case as hard to implement by the Member-States.<sup>70</sup> She holds that it is still unclear to what extend the situation of a taxable person in the other contracting state should be taken into consideration by the source state,

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<sup>68</sup> This conclusion was widened to also comprise monistic system like the French by the following case *Denkavit International* accounted for below.

<sup>69</sup> PricewaterhouseCoopers “Towards the end of withholding taxes?” International Tax Review, June 2006, page 1.

<sup>70</sup> Brokelind “The ECJ Boanich Case: The Capital Gains and Dividend Classification of Share Buy-Backs in Swedish Tax Law” European Taxation, June 2005.

since the tax-situation of Ms Boanich in France was not touched upon in the judgment. Ms Brokelind further brings up the practical problems with the assessment of the “global” tax exposure. She rightly points out that the source-taxation was formed with the intension to avoid such administrative intricacies that arises when tax-authorities have to interpret as well the effect of tax treaties, as the national legislations of other Member States.

It is inevitably so, that the tremendous amount of information that would have to be processed by that tax authorities could result in a counterproductive situation for the tax-payers, with an increase of handling-time, paper work and in the end - legal uncertainty. This, even though the Commission has provided for a tool through the *Mutual Assistance Directive*<sup>71</sup>, since it is still the up to the national tax authorities to value and apply the information provided.

## 1.7.2 Denkavit Internationaal

In the end of 2006, the awaited sequel to the *Bouanich*-case, the *Denkavit Internationaal*<sup>72</sup> judgment, saw the light of the day.

The structure of the company at hand constituted of two French subsidiaries and a Dutch parent company with substantial influence over its subsidiaries. The French legislation provided for a 25% withholding tax on dividends distributed to foreign parents. The tax was though limited by the France-Netherlands Double Tax Convention. The DTC assigned the taxation-right for dividends to the resident state of the receiving company, but with a possibility for the source state to withhold no more than 5% tax if the ownership exceeded 25% of the subsidiary. In order to avoid double taxation, the convention granted for a credit-system in the Netherlands for the source tax paid in France. Companies with resident parents were given a different tax-treatment. For groups falling under the “parent company” tax regime dividends were almost totally exempt in the receiving company’s hand.

Hence, when the Denkavit-subsiaries distributed their profits, the dividends were inflicted with a 5% withholding tax. In the receiving state, the Netherlands, profit distributions from foreign subsidiaries were exempt from the taxable income of the parent, therefore no credit was given. Consequently, the profit of the subsidiaries was taxed twice in the France, once as a corporate profit and once with a source-tax upon distribution. Denkavit International protested against the French tax-authorities and

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<sup>71</sup> Council Directive 77/799/EEC amended by Council Directive 2004/56/EC concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, certain excise duties and taxation of insurance premiums.

<sup>72</sup> Case C-170/05 *Denkavit Internationaal BV* [2006] ECR I-0000.

claimed to be discriminated by French legislation because of the residency of their parent company.

The Administrative Court in France, before which the claim was brought, referred three questions to the ECJ. In the first question, it wanted to know whether it was contrary to Article 43 to impose a withholding tax on dividends paid by a French subsidiary to its foreign parent, when no such tax was imposed on dividends distributed to a resident parent.

In his opinion, The Advocate General Geelhoed explained the situation of company groups and how profit distributions within these are often inflicted with economic double taxation, arising when profits are taxed in the hands of the subsidiary and later on, in the hand of the parent. In order for the obligations under EC-Law to be fulfilled, the AG points out that if the double taxation is relieved for resident company-groups, the same has to be done for groups with non-resident parents. This was, according to Mr Geelhoed, not fulfilled in the present situation, and consequently the French legislation rendered for a breach of Article 43 of the EC-treaty. Further, the AG made it very clear that he does not find the justifications put forward by the French government convincing. The ECJ, referring to the Opinion of the AG, supported his conclusion and dismissed the legislation and any possible justification.

The second and third question were put forward by the French Court in order to disentangle the situation of the role of double tax conventions plays in the discrimination-assessment. The Court wanted to know whether the double tax convention such as the one between France and Netherlands, in which the withholding tax at source is allowed to be imputed from the tax on the dividends liable in the receiving state, could be taken in to consideration when assessing the situation of a taxpayer. The problem was further developed by the wondering if it turned out to be the tax situation in the receiving state that made the imputation-system impossible, would this still render for a discrimination by the source state?

By way of introduction, the ECJ recognized the Member States liberty to determine the connecting factors for the allocation of fiscal jurisdiction by means of bilateral agreements, and in doing so, it referred to as well *Saint-Gobain* as *Bouanich*. Nevertheless, the Court continued, does this not permit for the Member States to introduce discriminatory measures contrary to the Community rules.

AG Geelhoed held that the double tax conventions have to be taken into account when assessing whether a taxpayer is discriminated. This because

the Member States have the freedom to apportion as well tax jurisdiction as the priority to taxation between themselves. Geelhoed refers in this matter to *Gilly*, from which it was understood that the sole allocation of fiscal jurisdiction does not render for discrimination. From this, the AG the conclusion that it is in principle non-discriminatory for the source state to impose an economic double taxation by withholding taxes, if these are relived by the receiving state. The AG further observes that the double tax treaties have to be taken into account in order to assess the economic reality of the taxpayer. He supports his opinion on the *Bouanich*-case with the words "...it is in principle open to a Member State to ensure a fulfilment of its obligations under the Treaty free movement provisions by means of provisions contained in a DTC."

AG Geelhoed concludes, that in order for the national legislation in combination with the DTC to not be discriminatory, the individual non-resident taxpayer's situation has to be compared and equal to a resident correspondent. Furthermore, it is up to the Member State which national measures are *prima facie*, to ensure that this non-discrimination is achieved.

The Court clarified the situation at hand, by stating that the DTC in this case does not eliminate the discriminatory effects of the legislation and dismisses the French standpoint, that it is up to the state of residence to rectify the effects of double taxation. By means of that last standpoint, the Court confirms the borders for the principle of tax treaties in relation to the conformity of national legislation with Community Law. In conclusion; the mere existence of a DTC does not disclaim a Member State of its obligations under the EC-treaty. Nevertheless, the existence of a DTC that in effect actually puts the harmed taxpayer in the same position as a national equivalence is ensuring for the Member State to be in conformity with EC law.

The *Denkavit*-judgment has caused a great stir in among tax lawyers. As the criticism comes from both extremes, one could draw the conclusion that the ECJ has found a perfectly balanced happy mean. Or, as interpreted by Prof. Vanistendael, the judgment is disappointing to, on one hand "the European enthusiast because of the limits on how far the ECJ will stretch the fundamental freedoms are much clearer now, on the other hand, the diehards of national sovereignty, because it is clear that the ECJ is not going to turn its back on its earlier decisions."<sup>73</sup>

One author, Mr Pons, sees the judgment as illogical because of the too narrow scope of taxation-systems that the ECJ has taken into its assessment. The author advocates a solution where the comparison is not limited to the

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<sup>73</sup> Vanistendael "Denkavit Internationaal: The Balance between Fiscal Sovereignty and the Fundamental Freedoms?" European Taxation, May, 2007.

taxation on shareholder level, but extended to “a more global level”. To support of his view, he explains that the French parent companies, which are exempt from tax, are in general only intermediaries redistributing the profits to tax-liable shareholders. If it could be taken into assessment that the dividends will be taxed a later stage, Mr Pons concludes, the non-granting of exemptions for non-residents would be less discriminatory.<sup>74</sup>

This theory has some obvious weak points. Mr Pons does not seem to consider the possibility that the tax-situation in the state of the receiving company could correspond to the one in France. Nothing indicates that the dividends would not be taxed upon distribution to a final shareholder, just because they are exempt when received by the direct shareholder. Mr Pons further promotes the idea that *all* taxes, direct as well as indirect, should be taken into consideration in the discrimination-assessment. This is in practice very problematic, as has already been touched upon by Ms Brokelind in her comment on the *Bouanich*-case.<sup>75</sup>

In one article the authors, Mr Bellingwout and Baranger, theorises about how the application of the AG’s Opinion stands in relation to the German withholding system.<sup>76</sup> The authors explain the German system to not be discriminatory at the dividend level, as irrespective of the residency of the parent, the profit distributions are inflicted with a 20% withholding tax. Nevertheless, the resident parents are entitled to a credit for the paid tax against their final corporate income tax liability or a refund in the case of an excess credit. Non-residents parents, not liable to CIT in Germany, are not entitled to a refund for the withholding tax and in many cases neither to a credit against the tax liability in their home state. Nevertheless, in some of the cases, like with Sweden, the double taxation is relieved by a DTC, reducing the withholding to nil.

Correctly, the authors notices that the question of discrimination is dependant on the treatment of the taxed dividends in the receiving state. If the parents home state use a participation exemption-system then a double taxation inexorably arises. If such system is not applicable to the situation at hand, and the tax is fully credited in the hands of the parent then Germany is obviously not in breach of Community Law. The authors concludes that by this example it is made clear that AG Geelhoed did, by stating that it is the source states responsibility to eliminate the double taxation, not intend for the interpretation to be made that the elimination has to be carried out in the actual source state. They further conclude that as long as the source taxation is fully credited in the receiving state, a breach of the EC-Law is not at

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<sup>74</sup> Pons “*The Denkavit Internationaal Case and Its Consequenses: The Limit between Disortion and Discrimination?*” European Taxation, May, 2007.

<sup>75</sup> See note 69.

<sup>76</sup> Bellingwout & Baranger “*The Advocate General’s Opinion in Denkavit II*” European Taxation, September 2006, p. 457.

hand. That is true irrespective of whether the German withholding tax is credited against the parent corporate tax liability on the basis of its domestic tax legislation or due to a tax treaty.

I fully agree with the above. As we now know, the ECJ on the whole followed the AG's opinion, giving the Member States a relatively clear principle on source taxation to rely on. To put it shortly, no matter which of the involved Member States national legislation or tax treaty affects the taxpayer, it is the collected practical effects of these, that are the basis for the discrimination-assessment.

## **1.8 Another approach – Fokus Bank**

At the time when the ECJ-rulings came, the EFTA-Court had, in its *Fokus Bank*-judgment<sup>77</sup>, already put some pressure on the withholding tax-system. This is of interest to this thesis since Article 40 of the EEA-Agreement bears the same objectives as Article 56 of the EC-treaty, namely to eliminate restrictions between Contracting Parties on the movement of capital and the discrimination based on nationality in relation to this. The EFTA-Court has in several judgments confirmed relevance of the ECJ-case law when applying the EEA- Agreement. Consequently, the interpretation of the EEA-agreement is an interpretation of the EC-Treaty and the ECJ-case law.

The *Fokus bank* issue concerned a Norwegian source tax of 15%, levied on dividends from resident companies on distributions to non-resident shareholders. The resident shareholders were taxed for the dividend-income as "general income" and could set off the tax paid in the subsidiary against the income tax in the parent, a system referred to in the judgment as an "imputation credit". Non-resident shareholders had the possibility, on the basis of the applicable DTC, to credit the taxation at source against the corporate income tax in their state of residence.

The questions referred to the Court were if it is inconsistent with Article 40 of the EEA-Agreement to have an imputation tax credit that is not granted non-resident shareholder and whether it makes any difference that under a DTC, the home state is obliged to grant tax credit for the tax withheld in Norway.

The Court did not accept Norway's claim that the difference in treatment had simply sprung from allocation of taxing rights. Further did the Court, through regarding the purpose of the disputed tax benefit, dismiss the

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<sup>77</sup> Case E-1/04 *Fokus Bank ASA v The Norwegian State* [...]

argumentation that the taxpayers were not in comparable situations. Since both resident and non-resident taxpayers run the risk of being exposed to the economic double taxation the benefit is aimed to eliminate, the Court reasoned, this should lay the relevant base for the comparison. Consequently, only if all shareholders were given the benefit of an imputation credit, irrespective of their places of residence, would the legislation not render for discrimination.

The Norwegian State tried to justify the discrimination by referring to the cohesion of the international tax system. This argument was rejected by the Court, holding that the rights granted by the EEA-agreement could not be made dependant on bilateral tax-treaties, as this would unduly give the DTC preference over EEA-law.

The role of tax treaties was dealt with further on in the judgment as Norway held that the credit given the shareholders by the DTC in the home state made the overall tax treatment equal. Here, the EFTA-Court takes an unexpected turn. It states that no matter what treatment the dividends have in the receiving state, a withholding tax like the one levied in Norway is an unjustified discrimination. This is an attitude that clearly differs from the ECJ-judgments, and that gives the Member States a significantly smaller field to play on. The EFTA-Court motivates its standpoint by stating that “A Contracting Party cannot shift its obligation to comply with the EEA-Agreement to another Contracting Party by relying on the latter to make good for discrimination and disadvantages caused by the former’s legislation.”

# Compensating Benefits

One could say that the stumbling block in the presented judgments boils down to to what extent a Member State can legitimise its discriminatory treatment of a taxpayer by presenting other factors affecting his situation and neutralising the mistreatment. In the cases in question those factors were the DTC:s and, to a certain extent, other Member States national legislations. The discussion on compensating benefits is definitely not a new, but indeed a highly controversial one.

The general conclusion among scholars is that there is no possibility for the Member States to justify themselves by referring to other aspects affecting the taxpayer. In other words, the view of the ECJ is interpreted to be that the demand set up for a non-discriminatory national legislation is an absolute one. This opinion is based on for example *Avoir Fiscal*<sup>78</sup>, in which the Court held that:

“Even if such advantages would actually exist they can not justify a breach of the obligation laid down in Article 52 ECT to accord foreign companies the same treatment.”

Another judgment supporting the view is the *Saint Gobain*<sup>79</sup>, dealing with the denial of double tax relief for dividends received by a permanent establishment. The justification put forward by the government was that the absence of withholding tax on the repatriation of profits from the permanent establishment to the foreign head office compensated the disadvantage suffered. The Court, stating that other advantages for permanent establishments could not justify the less favourable treatment they suffered in comparison with resident companies, rejected this argument.

On the other hand, there are some indications that the constantly growing intricacy of, and pressure on, the EC tax law has pushed the Court in the more accepting direction. For example in the *Gerritse*<sup>80</sup>-judgment, on the treatment of cross-border workers, the conflict arose from the imposition of a flat withholding tax on non-residents instead of the progressive tax as for resident taxpayers, in this way possibly increasing the tax burden for non-residents. The Member States defended the systems by arguing that the disadvantage of the withholding tax was compensated by the avoided increase in tax rate that would arise if the host-state income was taxed as a part of the progressive system. Although in this case the Court found that an

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<sup>78</sup> Case C- 270/83 *Commission v French Republic* [1986] ECR at 273.

<sup>79</sup> Case C-307/97 *Compagnie de Saint-Gobain, Zweigvereinbarung Deutschland v Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.

<sup>80</sup> Case C-234/01 *Gerritse* [2003] ECR I-5933.

advantage compensating the situation for non-resident taxpayers did actually not exist, it implicitly accepted the possibility of such an advantage being taken into account.<sup>81</sup>

Furthermore, in the case of *Manninen*<sup>82</sup>, the ECJ took the approach that there is a possibility of weighing in an advantage enjoyed by shareholders in foreign companies, as regards the underlying corporate income tax in relation to shareholders in domestic companies. By the ECJ accepting that such differences could be taken into account, there was another indication on the opening up for the possibility to use compensating benefits. A difference to be noticed between *Maninnen* and the cases on withholding tax is that the double taxation in the former case was due to a combination of foreign and domestic taxes, while in the case of withholding, the double taxation solely arises as a result of the tax system in the source state. The ECJ held in *Manninen*, that under the premises in the case, if the resident state takes action to eliminate the double taxation, the source state is relieved from such obligation.

The standpoint of the ECJ was further upheld in as well the *De Groot*<sup>83</sup>-judgment as the *Royal Bank of Scotland*<sup>84</sup>. In the later case, the ECJ used a common system of computing the taxable base in order to assess whether different tax rates rendered for a discrimination. This view is showing similarities with the discussion of “global tax exposure”, presented by the Court in the withholding-tax cases.

Obviously, the ECJ is having some sweat in taking a clear stand when it comes down to what basis to use when assessing the situation of a taxpayer and indeed, the question is a tricky one. There is inevitably a grey area of factors possible to weigh in when looking at the full picture of a taxpayer’s situation. On one hand, it is accurate to extend the list of aspects taken into consideration as far as possible, as this safeguards the adequacy of the estimation and furthermore enhances the picture of the EC as a flexible and non-bureaucratic institution. On the other hand, giving the Member States the incitement to pass discriminatory legislation, with the hope that it will be evened out by other factors, is clearly counterproductive to the objective of the Internal Market. Furthermore, as already pointed out<sup>85</sup>, it would turn into an unbearable work burden for the tax authorities and national Courts when having to estimate the impact of all the systems a taxable subject is exposed to.

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<sup>81</sup> van Thiel “Free Movement of persons and income tax law: The European Court in search of principles” International Bureau of Fiscal Documentation, 2002, vol 3.

<sup>82</sup> Case C-319/02 *Manninen* [2004] ECR I-0000.

<sup>83</sup> Case C-385/00 *De Groot* [2001] ECR I-3801.

<sup>84</sup> Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651.

<sup>85</sup> Brokelind “The ECJ Boanich Case: The Capital Gains and Dividend Classification of Share Buy-Backs in Swedish Tax Law” European Taxation, June 2005.

# Conclusions

We have established the fact that double taxation is unwanted. Further have we found out that the imposition of withholding taxes renders for such a double taxation. It has become clear to us that the Member States are at the present curbing this predicament with treaties based on the OECD Model. Now the question withstands, is this effort sufficient? Is a taxpayer, covered by a DTC that aims at settling the indecorous of his situation in the other contracting state, not discriminated?

It is obvious that the problem is of great importance. The Commission has indicated how source taxation constitutes a hazard to the Internal Market by issuing several directives prohibiting the same. Nevertheless, numerous situations fall outside the scope of these Directives and the harmonisation-situation for direct taxation in the EC is not indicating that a legislative solution will see the light of the day in the near future.

One could argue that the issued Parent-Subsidiary and Interest and Royalty Directives should be interpreted as making up the borders of the actual demands on withholding taxation set up for the Member States. It is of certain logic to acknowledge that if *all* source taxation was against Community Law, then issuing directives forbidding only *certain* withholding tax would be superfluous and confusing. Nevertheless, this logic is not necessary applicable to the logic of Community Law. The importance of the separation of powers<sup>86</sup> renders for the avoidance of omnipotence for any of the Community-organs. Consequently, the fact that a legislature action is omitted, or made impossible by the political situation, does not mean that the Courts cannot interpret already existing legislation to cover the discussed area.

So, in the unclarity of the situation, we are left with interpreting the vague guidelines of the Commission and the somewhat unpredictable case-law of the ECJ.

In my opinion, the answer to the question to what extend a DTC should be taken into account in the discrimination-assessment, the answer should be; to the full extend. Not only are the DTC actually a part of the national legislation in many states, but they are weathered and reliable tools for the Member States to use in solving issues arising from international trade. As long as there is no legislative harmonisation-process, the Member States are

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<sup>86</sup> The theory, that the authority has to be divided between the legislative, judging and executing power, is aiming at protecting the freedom of the citizens. The roots can be traced back to the philosophers of the Classical Antique and Middle Ages, but the theory in its modern form was presented by *Montesquieu* in “*De l'esprit des lois*”, 1748.

keeping their wide variety of legislative traditions. In this jumble of *Civil law* and *Common law*, *monistic* and *dualistic*-views, in new democracies and old legislative traditions, which the European Union actually consist of, there is no basis for dismissing the use of convention as unsatisfying. Maybe if the EU grows with the intention of becoming a standardization-project, on the expense of the Member States sovereignty, then we can discuss if there is a formal demand on how the legislative process should be formed.

The ECJ obviously follow the same line of reasoning. As the recent judgments has fallen we have understood that the actual core of the issue is not *which legislation* is affecting the taxpayer, but *how the legislation* is affecting the taxpayer. Now, how will this revelation affect the withholding taxes in the EC?

In my opinion, the recent judgments are not necessary a death-sentence for the source taxation. It all depends on how the tax treaties and the national legislation of the source state are formed. The primary question to look at in this issue is the point of reference, which is the resident taxpayers.

The discrimination arises as the Member States eliminate double taxation within national company groups, but expose non-resident to it. It is at a Member States discretion to not grant any of the credits or exceptions usually following dividends received by resident companies. By doing so, it would open up for a possibility to levy withholding tax on profit distributions to their non-resident equivalences. Consequently, if a Member State persists in eliminating economical double taxation within national company groups, like the Swedish rules on *näringsbetingade andelar*<sup>87</sup>, then they have to be prepared to give up their withholding taxation.

It should of course be noticed that the solution of applying non-discriminatory double taxation to all shareholders, is neither preferable, nor likely to be implemented by the Member States. The pressure on company taxation is already great, with the explosion of globalisation and mobility of taxpayers, for the nations to actually choose to worsen the situation for their residents in order to equalize them with non-residents, instead of improving the status of the latter.

As I interpret it, source taxation on dividends distributed to natural persons can in general be sustained. The principle in a vast majority of the Member States is that double taxation should be avoided on profit distributions within company groups, but dividends received by a resident natural person are taxed. As long as the foreign dividends are exempt in the home state of

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<sup>87</sup> Skattefri kapitalvinst och utdelning på näringsbetingade andelar. Prop. 2002/03:96. Utgiven:, 13 mars 2003.

the shareholder, the source state can impose a withholding tax on the profits leaving its jurisdiction, making the tax treatment equal to that of a residence shareholder.

As for the situation of withholding taxes on interest and royalty-payments, the question obviously does not cause as upset emotions as the one for dividends. This is of course related to the fact that the application of the rules usually employed on these kind of transactions does not render for the treatment to be discriminatory. As understood from the OECD Model and the common practice of the Member States, the conventions are usually formed to allocate the taxing rights for these incomes to the state of residence; hence, no withholding tax is levied. In the cases that the source state actually has gained the right to tax, the companies are still affected by only one tax, namely the withholding one, and consequently no double-taxation is at hand. This of course provided that the situation is covered by a DTC, or the payment is in another way exempt in the receiving state.

In conclusion, the ECJ has by its latest judgments not necessary issued a death sentence on withholding taxes. None the less could this kind of taxation draw to the close irrespective of its discriminatory status. The future of company taxation as such, is somewhat unclear. The fatalists in this question hold that “the race to the bottom” has already begun and will not end until direct taxation has completely vanished. This might be to strain the situation a bit, but I am nevertheless convinced that some decontamination in the national tax systems will be necessary in order to meet the new reality of the mobile tax base. Possibly, but not certainly, by the giving up of withholding taxation.

A positive aspect of the judgments is that the ECJ has affirmed that the international practice of settling cross-border activities, through the DTC:s, is and will most probably continue to be a relevant part of the Member States legislations. This is a wise choice by the Court, showing respect for the Member States wish to keep their sovereignty on direct tax issues by not interfering where it is not necessary.

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