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Most-Favoured-Nation Treatment in an EC Tax Law Perspective

A Special Focus on the Principle's Effect on the Limitation on
Benefits Clauses in Double Taxation Conventions

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Summary

The Most-Favoured-Nation treatment has been a common feature in international economic relations for a long period of time. The principle provides for equal competitive opportunities between contracting states and has been a standard in the field of trade, investment and other areas of economic co-operation. Although its application to these fields of law is widely accepted, the principle has still not been welcomed in direct Community tax law. The European Court of Justice has for quite a long period of time avoided the topic, but the issue has once again been brought to the Court's attention in three similar cases. Perhaps the question will be decided once and for all in these pending cases.

There are many supporters of a 'limited' Most-Favoured-Nation treatment in the field of direct tax law. The 'believers' find that the general non-discrimination principle also applies to discrimination between non-resident taxpayers of different Member States. By not considering the Most-Favoured-Nation standard as a principle of its own, the consequences are limited. The treatment merely is another form of discrimination and the ordinary justification grounds are applicable. The condition that the two non-residents must be in a similar situation counteracts far-reaching effects.

The Limitation on Benefits articles, included in several international tax treaties, have a purpose of avoiding tax treaty shopping. The criteria of the articles are designed to ensure that the residents of a contracting state are not used as conduit companies for shareholders resident in less favourable tax regimes. Many scholars believe that these provisions violate the fundamental freedoms enshrined in the Treaty establishing the European Community. The qualification tests included in the Limitation on Benefits clauses are not a proportionate means to avoid tax evasion or tax avoidance.

The main purpose of the thesis is to analyse how the Most-Favoured-Nation doctrine and the Limitation on Benefits articles interact. If a taxpayer claims entitlement to a treaty benefit, both according to the Most-Favoured-Nation principle and by annulment of a Limitation on Benefits provision, which one prevails and can the two features lead to different results? The conclusion that the author makes in this paper is that if a Limitation on Benefits clause is violating Community law, the whole tax treaty will be annulled. The parties then have a possibility to re-negotiate the conditions of the agreement without leaving the treaty benefits entirely undefended. The 'limited' Most-Favoured-Nation principle extends the applicability of a *specific* tax treaty benefit in a *specific* case, not *all* treaty benefits in *every* case, unlike the result of a possible annulment of a discriminatory Limitation on Benefits clause. If a discriminatory Limitation on Benefits article is found justified by Community law, but the Most-Favoured-Nation treatment extends a certain tax treaty benefit in the same agreement, the latter more specific non-discrimination principle must prevail.

Preface

I got the inspiration to this project in January 2005 when I read the Opinion of the Advocate General in the 'D' case. The Most-Favoured-Nation Treatment had been up to discussion for quite a long period of time and it caught my attention. Much had been written about the topic, but the Opinion of the Advocate General shed some new light on the issue. The 'D' case deals, *inter alia*, with a taxpayer's possible access to treaty benefits within the European Union in line with the Most-Favoured-Nation doctrine. Mr. D claims that German and Belgian non-residents are in the same situation in the Netherlands regarding net wealth tax. Due to the fact that these non-residents are treated differently, the Netherlands is violating Community law according to Mr. D. Time will tell if the European Court of Justice shares his opinion. In the meanwhile a person can only guess the verdict of the Court and its implications.

Just when I was considering writing a thesis merely on the subject of this disputed principle, I suddenly had the *Open Skies* decisions in my hands, eight cases dealing with discriminatory nationality clauses in bilateral air service agreements with the United States. The judgements also relate to access to treaty benefits as the 'D' case does, but the *Open Skies* decisions go beyond a purely Community point of view. The nationality clauses have much in common with Limitation on Benefits provisions, which are ordinary features in bilateral income tax treaties. This aspect made these decisions interesting and could be regarded as a contribution to a wider view of an analysis of access to treaty benefits.

After some basic research on these judgements and their influence on tax law, I concluded that the interference of Community law regarding the two characteristics, Limitation on Benefits clauses and the Most-Favoured-Nation doctrine, could lead to similar results. In other words, the invalidation of a discriminatory Limitation on Benefits clause can result in a situation where a non-qualified taxpayer is entitled to a tax treaty benefit. This is also possible if the benefit is extended to persons initially not entitled to them by the Most-Favoured-Nation doctrine.

Finally, I would like to express my gratitude to my tutor Cécile Brokelind who carefully read the whole manuscript and gave here opinion on the thesis. She is a person that inspires me to constantly improve and without her inspiring lectures I would not have written a thesis on the subject EC tax law.

Anitza Zester

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Abbreviations

Bulletin	Bulletin for International Fiscal Documentation
CFE	Confédération Fiscale Européenne
DTC	Double Taxation Convention
EC	European Community
EC Treaty	Treaty establishing the European Community
ECJ	European Court of Justice
EU	European Union
GATT	The General Agreement on Tariffs and Trade
IBFD	International Bureau of Fiscal Documentation
LoB	Limitation on Benefits
MFN	Most-Favoured-Nation
OECD	Organisation for Economic Co-operation and Development
O.J.	Official Journal of the European Communities
UNCTAD	The United Nations Conference on Trade and Development
WTO	World Trade Organisation

1 Introduction

The European Court of Justice can rule on matters dealing with the EC Treaty freedoms and set aside rules of national law that would be detrimental to these freedoms. As the Court concluded in 1986 in the *Avoir Fiscal* decision¹, these principles also extend to direct taxation, a field normally outside the exclusive Community competence. The Member States cannot apply tax rules that discriminate against nationals of other countries, nor must they create a barrier to the exercise of the EC Treaty freedoms or make this exercise less attractive. At the present moment it is unnecessary to deny the authority of the European Court of Justice in these situations. When a Member State's national legislation violates the fundamental freedoms of the EC Treaty, the Community has the power to act on this infringement.

The EC Treaty does not only grant internal powers on the Community. In certain specific areas, the Treaty confers external competence. This external power may not only be gained explicitly but also by the doctrine of implied powers. This leads to the conclusion that the competence of the Member States to conclude bilateral tax treaties with third countries, may be questioned and restricted.² In other words, the double taxation conventions of the Member States are submitted to the non-discrimination principle.

Several Member States have clauses in their double taxation conventions, which exclude resident corporations without a sufficiently strong nexus to the contracting state from the treaty benefits. These articles are often referred to as Limitation on Benefits clauses. Due to the Court's competence in this field, the taxpayers may challenge these provisions if they have restricting effects.

Even if it has been reaffirmed that the double taxation conventions of the Member States are submitted to the non-discrimination principle, it is nevertheless not clear if a Most-Favoured-Nation treatment does bind Member States when applying the treaties. The Most-Favoured-Nation treatment is a well accepted principle in trade and investment agreements and a general unconditional Most-Favoured-Nation obligation can be found in Article I of the 1994 GATT. The Article states that any advantage, favour, privilege or immunity granted by a Member to any product originating in or destined for any other country shall be accorded immediately and unconditionally regarding that product to all other contracting parties. Its purpose is to avoid economic distortions and to ensure equality aspects in trade law. Even though the principle has never

¹ Case 270/83 (Commission v. France).

² From Case 22/70 Commission v. Council, the *AETR* case, or the *ERTA* case as it also is referred to, it appears that the Community is competent to conclude international agreements necessary to attain an objective, which confers internal power on the Community. See further discussion on this issue in chapter 2.2.2.

been used in direct EC tax law, its applicability in this field has been disputed in doctrine. Due to recent legal actions referred to the European Court of Justice³, the Court can decide upon the future evolution of the Most-Favoured-Nation principle in direct tax law. The pending cases give the Court the opportunity to determine whether such treatment can be deprived from the EC Treaty or not. Thus, maybe affect indirectly the future use of Limitation on Benefit clauses in the Member States' double taxation conventions.

1.1 Subject and Purpose

The subject and purpose of this study is to analyse the recent development of the Most-Favoured-Nation treatment in direct Community tax law. This issue is widely discussed nowadays and will here be given a rather diverse approach by investigating how the principle can affect the Limitation on Benefits clauses within bilateral tax treaties.⁴ The two topics are most definitely not smoothly brought together. Even the mere existence of the Most-Favoured-Nation treatment in direct EC tax law is already controversial in it self, due to equality aspects. There will always be 'free rider' situations, causing problems of contractual imbalance between countries. A general application of the Most-Favoured-Nation principle does not take into consideration reciprocity matters, which are of interest for the waiver of taxation rights agreed upon by a Member State. International tax treaties are the result of bilateral negotiations where benefits are granted to the residents of the two states on the basis of reciprocity. The Most-Favoured-Nation treatment can undermine this balance.

The difficulty in bringing the Limitation on Benefits clauses and the Most-Favoured-Nation principle together can be explained by their inherent purposes. The two features have been established for different reasons. The Limitation on Benefits clause, LoB in short, is taking the tax interest of the single state into consideration, while the Most-Favoured-Nation treatment, MFN, lessens this state's influence to the advantage of the taxpayer. The MFN principle is a positive tax measure unlike the LoB clauses, which intend to restrict the benefits by only giving these to parties with a strong nexus to the contracting state. These clauses are drafted as a compromise between two states when concluding a tax treaty. This 'give and take' has no correspondence in the MFN treatment, which instead is a means of preventing the restricting effects that comes with the tax practice of a state.

³A preliminary question was put to the ECJ on the 24 July 2003 by the Netherlands, the 'D' case, C-376/03. One of the most recent judgements referred to the ECJ for a preliminary ruling is the *Bujura* case, C-8/04, received on 12 January 2004 and put forward by the Netherlands as well. Another pending case is the *ACT Test Claimants* case, C-374/04. The preliminary question, which was referred to the ECJ by the United Kingdom, was received on 30 August 2004.

⁴ See the different approaches to the applicability of the principle in chapter 4.

The foremost purpose of the thesis is, as explained above, to analyse how the MFN doctrine and the LoB articles interact, or if they can affect each other at all. The questions that the author wishes to answer are:

- Can the application of the MFN standard and the invalidation of a LoB provision lead to different results?
- Can the Court's judgement of relevant justification grounds in a case where both the MFN treatment and LoB clauses are examined, lead to two different results?
- If a taxpayer claims entitlement to a treaty benefit, both according to the MFN principle and by annulment of a LoB provision, which one will prevail?

1.2 Delimitation

The analysis made in this thesis will more or less be limited to three areas of law. The competence of the Community and the interaction between different sources of law will form an introduction to the examination of the MFN treatment and the LoB clauses. The thesis will be limited to how the MFN treatment can influence the interpretation and future application of the LoB provisions. The study will not contain an exhaustive survey of all the variety of LoB clauses used in current double taxation conventions. The most frequently applied clauses will be examined thoroughly in the light of the principles found in the EC Treaty.⁵ The effects of finding the LoB clauses in conflict with the fundamental freedoms will also be left aside. Some examples of such consequences are state liability for damages, which might affect the Member States, or application of the state aid rules. These principles will only be described shortly.

The chapter concerning the different sources of law is not supposed to be understood as an exhaustive exposition. These questions can form a thesis of its own and therefore this section must be recognised as a mere summary and explanation of how the author understands and interprets the sources. Another limitation is that the author will not give a detailed review of the proposed and much debated solutions to counteract the potentially problematic interaction between tax treaties and Community law, such as an EU Multilateral Tax Treaty or an EU Model Tax Convention.⁶

The author's intention is to give a general overview of the MFN treatment and the LoB provisions. Therefore, there are several aspects that only are

⁵ For an exhaustive survey of the LoB clauses the author refers to Georg W. Kofler, *European Taxation Under an 'Open Sky': LoB Clauses in Tax Treaties Between the U.S. and EU Member States*, Tax Notes International 2004 pp.45-89.

⁶ Guglielmo Maisto has addressed this issue in his article *Shaping EU Company Tax Policy: The EU Model Tax Treaty*, European Taxation 2002 pp.303-308, and Pasquale Pistone as well in *The Impact of Community Law on Tax Treaties – Issues and Solutions* and in *An EU Model Tax Convention*, EC Tax Review 2002/3 pp.129-136.

briefly mentioned. Possible negative aspects of applying the MFN standard or invalidating the LoB clauses are not addressed in this paper. The scholars, who are against such a development, have given numerous of examples of situations where, for instance, the application of the MFN principle will lead to unreasonable results. The paper will not extend to this research that is of importance if the European Court of Justice, ECJ, for example, would welcome a general and unconditional MFN principle.⁷

1.3 Method and Material

The most commonly applied method for judicial research in general is the legal dogmatic method. This descriptive and analytical technique is also used in this paper. The study focuses on the legal sources and a thorough inquiry of doctrine in the area is made. Books and articles in international tax journals are the basis of the thesis. Moreover, the case law of the ECJ is unquestionably of great importance to the thesis.

In a field like EC tax law, the different personal opinions of the academics are of considerable weight. The attitude of the scholars, explicitly if they are positive or not to the development of the case law of the ECJ, is taken into consideration. In several articles the scholars express their opinion very clearly and straightforward. This makes it easier to understand how and why an academic comes to the conclusions that are to be found in the text. When the fundamental opinions are well hidden, attention will be paid to discover these beliefs. If the scholar's assumption remains obscure, his or her conclusions are carefully reconsidered. If other academics support the outcome, the theory gains in value.

1.4 Outline

The paper can roughly be divided into three main parts, as mentioned earlier. First, an introduction will be given, containing a brief presentation of the different sources of law and the competence of the Community. The competence of the Community has its centre of attention on how it affects the Member States' future power to conclude bilateral tax treaties. This section is of importance to understand the subsequently made conclusions in the other chapters. The first part of the thesis expresses basic conditions for the other more important parts of the paper.

⁷ John F. Avery Jones has analysed some consequences in *Flows of capital between the EU and Third countries and the consequences of disharmony in European international tax law*, EC Tax Review 1998/2 pp.95-106. Stefaan De Ceulaer has some examples in *Community Most-Favoured-Nation Treatment: One Step Closer to the Multilateralization of Income Tax Treaties in the European Union?*, Bulletin 2003 pp.499ff and Klaus Vogel in *Problems of a Most-Favoured-Nation Clause in Intra-EU Treaty Law*, EC Tax Review 1995/4 pp.264f.

Secondly, there will be an analysis of the MFN treatment and of the possibility to use this principle in direct EC tax law. There will be a general overview of the doctrine with a special focus on recent case law of the ECJ.

Thirdly, the LoB clauses will be in the focal point, especially the ones mentioned in the 1992 Netherlands-United States income tax treaty. The overall question to be answered in that section is the compatibility of the LoB clauses with EC law. Due to recent case law of the ECJ many scholars have questioned the future existence of these clauses. Obviously, a clear and unambiguous answer cannot easily be found at the present moment. Nevertheless, this is not the foremost aim with this paper. The analysis of these clauses, and not a specific answer to the enquiry, is the main purpose with the work. It appears that LoB clauses are not identically drafted, which leads to a difficulty in predicting every different wording's compatibility with EC law.

Lastly, the two latter areas will be brought together with the aim of analysing different outcomes when the two characteristics are applied to the same income tax treaty.

2 Different Sources of Law and Community Competence

2.1 Three Main Systems of Law

Various sources of law may be applicable to a multinational organisation or to a person with several connections in different countries. At the national level the states have addressed possible non-taxation and double taxation inconveniences by entering into negotiations with other states. Such collaborations often result in bilateral double taxation conventions. Consequently, the existence of a double taxation convention, DTC, demands or assumes the existence of provisions in national law that addresses the actual situation. If there are not any national regulations in the same area as the DTC, there is no use of such an agreement between two States. There must always be different overlapping national provisions resulting in no taxation at all of the person or company, or double taxation of the taxpayer, to justify the existence of a DTC.

The bilateral tax treaties contain elements of national law as well as of EU law, because of the special position that Community law has in national law. EC law is a part of the Member States' national law system and must therefore be represented in the tax treaty law making. EC law is differently introduced into the national law systems of the Member States. The dissimilarities depend on a country's classification as a monist or a dualist state. Irrespectively of how Community regulations are brought into the Member States' national law systems, the countries must nevertheless accept the supremacy of EC law.⁸ Monist states, like for instance France, have a system of not transforming EC provisions into national law. Instead the EC rules become effective within the national legal order immediately when they are enacted by the Community. The dualist countries on the other hand, must implement the Community legislation before it can be applied in the Member States. Therefore, certain national rules with the same contents as the specific EC provisions must be passed at a national level. Sweden is an example of a country with a dualist implementing system, even if the approach is not constitutionally based. Although Sweden has a dualist system, it has in reality a monist attitude towards EC law. The country gives the EC Primary and Secondary law direct applicability, effect and enforcement according to Community principles.⁹

If EC law is seen as a part of national law or even as standing above the national law, there is no 'conflict' between Community law and

⁸ Case 26/62, the *van Gend & Loos* case, Case 6/64, the *Costa v. ENEL* case and Case 106/77, the *Simmenthal* case.

⁹ Bernitz, *Common Market Law Review* 2001 p.920f.

international law, explicitly the DTCs. The Member States have a responsibility to comply with Community law when concluding tax treaties according to Articles 10 and 307 EC.¹⁰ The international law and its bilateral tax treaties can be seen as an extension of the national law. Community law and its fundamental freedoms prevail over the bilateral treaties by virtue of hierarchy, *lex superior derogat de lege inferiori*.¹¹ It ought to be no different approach at the Community level if a discriminatory rule is found in the national legislation or in a DTC. If the Member States could avoid the Community law involvement by just introducing a discriminatory standard in international treaties instead of in national legislation, it would lead to unreasonable results.¹²

The supremacy of EC law concerns the negative aspects of different outcomes when a certain situation is covered by more than one source of law. EC law is not trying to sustain that a taxpayer is worse off by applying the established Community standards. The EC rules can be seen as a minimum standard for the taxpayers of the Union.¹³ A taxpayer can always choose the best treatment available regardless of if it is established by national rules, by international law or by EC provisions. These positive aspects resulting from the interaction of different law systems are not something that EC law wants to prevent.

Of course different results are at hand when the various sources of law interact, but is that the same as seeing the dissimilar outcomes as in conflict with each other? Some scholars are of the opinion that a conflict between tax treaties and Community law does exist and that the problem requires an urgent solution. Some academics have distinguished different categories of conflict and assigned to them diverse degrees of incompatibility.¹⁴

These question marks do not have any clear-cut answers, but here the author will make an attempt to describe her attitude towards these uncertainties. First of all, how do the three sources of law interact? The three legal orders, to be precise, national, international and EU law do not have the same purposes. A national tax law system has a purpose of politically allocating resources between citizens to prevent big discrepancies at a territorial level, for instance, in social standards. The national tax system also has purposes of assessing taxation rights and collecting revenue for the financial support of the public sector. There are more fiscal and non-fiscal functions behind

¹⁰ This issue will be further discussed in chapter 2.3.

¹¹ Hinnekens, EC Tax Review 1994/4 p.160, Kofler, Tax Notes International 2004 p.57, Pistone (2002) p.84.

¹² Weber, CFE Forum 2005 p.2. Here he points out that a provision in national legislation can have the same effects as an identical provision in a bilateral treaty. He does not see why bilateral treaties are special in respect to the examination of the Member States' justification grounds.

¹³ This minimum standard theory is well accepted, however not undisputed, see chapter 3.1 and Hinnekens, EC Tax Review 1994/4 pp.158-159, Pistone (2002) p.84.

¹⁴ For instance, Baker (1994) pp.59ff, Hinnekens, EC Tax Review 1994/4 pp.159f, Pistone, EC Tax Review 2002/3 p.129 and EC Tax Review 2005/1 p.6, van Unnik and Boudesteijn, EC Tax Review 1993/2 pp.109f.

the national tax structure, but they will not be further mentioned in this thesis. As described above, the bilateral tax treaties have a purpose of allocating taxation rights and the prevention of non-taxation or double taxation when two or more national tax laws are interacting.¹⁵ Then again, EC law is a source of its own. It cannot be considered as ordinary international law in the same manner as a bilateral treaty.¹⁶ It has a totally different purpose than the two earlier referred legal orders. Important purposes are the ones of free movement within the Community and equality aspects, specifically non-discrimination treatment amongst others.

Taking into account these different aspects and purposes, the conclusion the author makes is that there is not a 'conflict' between EC law and the Member States' DTCs. If different sources of law are applicable the outcomes can collide, but the order of hierarchy between them solves the issues. The ECJ has more than once expressed the primacy of Community law¹⁷ and with that view in mind, there can be no conflict between the legal orders. There is however not any clear support for the primacy of EC law in the EC Treaty or elsewhere in Primary Community law. On the other hand, a bilateral tax treaty is not established by itself, one day emerging out of nothing. The Member States must take part in the process and as a result they can be held responsible by the Community.¹⁸ According to Articles 10 and 307 EC, the Member States have a responsibility to ensure the obligations arising out of the EC Treaty in their tax treaties.

Some guidance might be found in international law or more explicitly in the Vienna Convention on the Law of Treaties. Contracting states are not allowed to amend a multilateral treaty, which the EC Treaty is, by concluding a bilateral treaty unless the possibility of such a modification is provided for by the multilateral treaty or not prohibited by the treaty. This simplified picture follows from Articles 40 and 41 of the Vienna Convention. Due to the fact that the EC Treaty is a multilateral treaty, it may be considered as having an automatic superiority compared to the later concluded bilateral treaties.

One example of a case dealing with tax treaties, different sources of law and how the ECJ solved this interaction is the *Gilly* case¹⁹. It was a dispute as to calculation of the personal income tax payable in Germany by a couple resident in France under the provisions of a convention between the two states. In this decision the ECJ dealt with national law when addressing a

¹⁵ See chapter 4.5 for further discussion about allocation of taxing power.

¹⁶ Hinnekens, EC Tax Review 1994/4 pp.160f.

¹⁷ See supra note 8.

¹⁸ See the *Open Skies* cases, infra note 53.

¹⁹ Judgement of the Court of 12 May 1998, Case C-336/96. The case dealt with the abolition of double taxation and the Court stated that Article 220 EEC, second indent (now Article 293 EC) did not have direct effect. This indent merely indicates the abolition of double taxation within the Community as an objective of negotiations between Member States.

problem of double taxation. The Court did not touch upon the allocation rules in the Member States' bilateral tax treaty in this ruling.²⁰

Even if there is not a 'conflict' at hand in these situations, it is important to analyse when the Member States have to adjust and accept the involvement of EC rules and regulations at a national level. The competence of the Community is certainly not infinite. Accordingly, what limitations are the Member States forced to accept in their tax treaty law making?

2.2 External Community Competence

The EC Treaty confers the internal competence of the Community, *in foro interno*. In certain specific areas of EC law the Treaty also grants an external capacity of the Community.²¹ The external competence of the Community, *in foro externo*, is the power in respect of the relation to third countries. In other words, in certain areas the Community has authority to conclude treaties with third countries. Article 281 EC confirms the legal personality of the Community, which is of great importance for the legality of the conclusion of such agreements.

As a general rule, the authority to conclude tax treaties lies within the Member States' own competence. Due to progress in the case law of the ECJ, this external power of the Member States may be restricted.²² These developments have given rise to some questions, *inter alia*, the extent of these limitations is debated. As an attempt to answer this uncertainty, the Community competence to conclude tax treaties with other states will initially be analysed here.

The Member States are most certainly of the opinion that in the absence of any Community action in the field, the external competence lies exclusively with them. The Community will no doubt say that it has competence, but surely not exclusive competence. Due to practical difficulties it would be impossible for the institutions to exercise such competence.²³ If the latter is true, then the question arises of how extensive this capacity of the Community to conclude such agreements is?

The doctrine of external competence was developed in the *AETR* case²⁴. Whenever the Community has internal powers to achieve a specific

²⁰ Daniels states in Intertax 2001/1 p.9 that 'from the *Gilly* ruling, I conclude that the Court did not assess adverse tax consequences from the interaction between tax systems and the tax treaties against the discrimination ban of European law, even if those adverse consequences arise because the tax treaty makes a link with the taxpayer's nationality'. See further discussion about allocation rules in DTCs in chapter 4.5.

²¹ For instance, Articles 111 (Monetary policy), 133 (Common commercial policy), 170 (Research and technological development) and 174 EC (Environment). See further about this explicit competence in chapter 2.2.1.

²² These restrictions may be based on the AETR doctrine established in the *AETR* case, Case 22/70.

²³ Avery Jones, EC Tax Review 1998/2 p.102.

²⁴ Judgement of the Court of 31 March 1971, Case 22/70.

objective, it also has external competence towards third countries to achieve that objective. In particular, each time common rules are adopted by the Community in a certain field, the Member States no longer have the right to undertake obligations with third countries that may affect those rules or alter their scope. The Court mentioned in this respect Article 10 EC, the principle of Community loyalty, and that the system of internal Community measures may not be separated from that of external relations.²⁵

From the *AETR* judgement some scholars have concluded that any possible external power of the Community as regards tax treaties with third countries cannot be exclusive. Instead the powers are shared between the Member States and the Community.²⁶ This line of reasoning can be further developed. The Community can receive an exclusive competence in specific areas in two situations. First, the Community gets exclusive power when it has included provisions in its internal legislative acts that deal with the treatment of citizens of third countries. Secondly, it acquires exclusive external competence when power to negotiate with third states is expressly conferred on its institutions.²⁷

2.2.1 Explicit Powers

The Community has external competence when the EC Treaty expressly says so, but also where the power is implied by the fact that the expressly mentioned competence cannot be effectively exercised without the help of 'implied powers'.²⁸ The implied capacity of the Community will be discussed further in chapter 2.2.2.

The EC Treaty contains a large number of provisions that assign the capacity of conclusion of agreements to the European Union, EU. These articles concern areas of law like environment, monetary and common commercial policies.²⁹ Article 300 EC lays down procedural rules and a distribution of powers between the Commission and the Council for the negotiation and the conclusion of these agreements.

The EC Treaty actually does not confer any external direct tax competence whatsoever, but the Community can extend its authority in the tax field by other means.³⁰ In respect of direct taxes, a number of Directives have been adopted: the Mutual Assistance Directive³¹, the Merger Directive³², the Parent-Subsidiary Directive³³, the Savings Directive³⁴ and the Interest and

²⁵ The *AETR* case, Case 22/70 paras. 17-22.

²⁶ Terra and Wattel (2001) p.111.

²⁷ Opinion 1/94 para.95, van den Hurk, EC Tax Review 2004/1 p.21.

²⁸ Terra and Wattel (2001) pp.110-111.

²⁹ Articles 111, 133 and 174 EC, van den Hurk EC Tax Review 2004/1 p.23.

³⁰ Terra and Wattel (2001) pp.111-112.

³¹ 77/799/EEC of 19 December 1977.

³² 90/434/EEC of 23 July 1990.

³³ 90/435/EEC of 23 July 1990.

³⁴ 2003/48/EC of 3 June 2003.

Royalty Directive³⁵. As a consequence, the Community now has external competence to conclude treaties for avoidance of double taxation with third countries in these areas.

Based on the *AETR* doctrine, it can be stated that in the field of the Directives, the Member States have lost their competence to conclude bilateral agreements if these settlements could jeopardise the full effectiveness of the tax Directives.³⁶ However, the scope of the agreements and the Directives are not the same. The tax treaties have a much wider scope than just a specific Directive or perhaps all of them. Another disturbing fact is for instance, that the Parent-Subsidiary Directive and the Merger Directive are limited to purely internal solutions. These Directives do not teach us anything about external relations. The mentioned facts do indeed give rise to some more uncertainties.³⁷

2.2.2 Implicit Powers

The authority to enter into international commitments may not only arise from an express attribution by the Treaty, but may equally flow implicitly from its provisions.³⁸ This is called the doctrine of implied powers and the theory is supported by the *AETR* and the *Kramer*³⁹ judgements as well as by several opinions⁴⁰ delivered by the ECJ. In the absence of specific provisions relating to the negotiation and conclusion of international agreements, one must turn to the general system of EC law in the sphere of relations with third countries.⁴¹

The Court has concluded, *inter alia*, that whenever EC law has created internal powers for the institutions of the Community for the purpose of attaining a specific objective, the Community has authority to enter into the international commitments necessary for the realisation of that objective. This is the case even in the absence of an express provision conferring such competence in that field.⁴² This is particular true in all cases in which internal powers has previously been used in order to adopt measures which come within the fulfilment of common policies.⁴³

The measures must not only be determined within the scope of the realisation of common policy, but the criteria *effectiveness* and *necessity* have to be met. The criterion effectiveness signifies that the Community is competent only if the internal power can be exercised *effectively* together with the external competence.⁴⁴ The necessity criterion has to make sure that

³⁵ 2003/49/EC of 3 June 2003.

³⁶ Rienks, *Intertax* 2004 p.569, Terra and Wattel (2001) p.111.

³⁷ Avery Jones, *EC Tax Review* 1998/2 p.102, Terra and Wattel (2001) p.112.

³⁸ Opinion 1/76 para.3.

³⁹ Judgement of the Court of 14 July 1976, Joined Cases 3, 4 and 6/76.

⁴⁰ Opinions 1/76, 2/91, 2/92 and 1/94.

⁴¹ The *AETR* case, Case 22/70 paras.12-14.

⁴² Terra and Wattel (2001) p.111.

⁴³ Opinion 1/76 para.4.

⁴⁴ Opinions 1/76 and 1/94 para.89, van den Hurk, *EC Tax Review* 2004/1 p.20.

the power only exists if an international agreement is *necessary* for the specific realisation and this could not be reached by other means, for instance, by a regulation.⁴⁵

2.3 The Territorial Tax Sovereignty and Bilateral Contract Freedom of Individual Member States

The EC Treaty makes few references to direct taxation. One of the few references is actually in the context of double taxation conventions, Article 293 EC. The Article states that the Member States shall, so far as is necessary, enter into negotiations with each other to secure the abolition of double taxation within the Community. Even if the area of direct taxation hardly is mentioned in the context of the EC Treaty, the ECJ has more than once stressed the importance of the principles and fundamental freedoms found in the legal framework and their impact on tax treaties.⁴⁶ A Parliamentary Answer regarding the issue also indicates this position. The Answer moreover addressed the question of conclusion of double taxation conventions, DTC, and confirmed that at the present this capacity remains a matter for the Member States.⁴⁷

In principle, the field of bilateral double taxation agreements is the competence of member states which they exercise with due regard for the principle and rules contained in the Treaty, such as the principle of nondiscrimination, respect for the fundamental freedoms enshrined in the Treaty and the obligation to cooperate to attain the Treaty's objectives. Elimination of double taxation is one of the Community's objectives.⁴⁸

As described above in the previous sub-chapter, the Community competence extends in certain situations to tax treaties which Member States conclude with third countries. Article 307 EC recognises, in a *contrario* reading, the general obligation of Member States to ensure the compatibility with EC law of their tax treaties with third countries.⁴⁹ If such

⁴⁵ Opinion 1/94 para.79, van den Hurk, EC Tax Review 2004/1 p.20.

⁴⁶ In the *Schumacker* case, C-279/93, the ECJ decided that the Member States were required to exercise their taxation powers on cross-border transactions in compliance with the primacy of EC Law. In the *Saint-Gobain* case, C-307/97, paras.56-58, the ECJ emphasised that these principles also applied when national powers were exercised by means of a treaty concluded with another Member State or a third country. The position of the Court was elucidated in the *Open Skies* cases, see *infra* note 53.

⁴⁷ Baker (1994) p.58.

⁴⁸ Written Answer, November 9, 1992, Question No.647/92, O.J. 93/C40.

⁴⁹ Article 307 EC, first and second indent, states:

The rights and obligations arising from agreements concluded before 1 January 1958 or, for acceding States, before the date of their accession, between one or more Member States on the one hand, and one or more third countries on the other, shall not be affected by the provisions of this Treaty.

agreements are incompatible with the EC Treaty, all appropriate steps to eliminate the incompatibilities shall be taken.⁵⁰ An obligation to act in compliance with the Treaty is also found in Article 10 EC.⁵¹ This Article codifies the principle of Community loyalty, which is one of the fundamental provisions that the ECJ relies on for the sovereignty and development of Community principles and powers, *inter alia*, the principle of implied powers. The Member States are put under two different obligations by the Article. First, the liability to co-operate and attain to positive measures and secondly, the negative Community loyalty, that is abstain from any jeopardising measures.⁵²

An elucidatory example in this area is the recent *Open Skies* decisions⁵³. The cases consider bilateral airline treaties, the so-called 'Open Sky' agreements, relating to the liberalisation of air transport between the European countries and the United States of America. The European states had not concluded identical treaties and this lead to negative consequences for the EU. The Commission was of the opinion that the treaties were incompatible with EC law and that such agreements should be negotiated at the Community level. The ECJ shared the Commission's view and demanded re-negotiations of the agreements.

It seems that the area of direct taxation must in these circumstances be equally treated as the other more harmonised fields of law. The *Open Skies* cases have elucidated the position of the ECJ, even if the cases have not enforced more influence of EC law on tax treaties. Nevertheless, the decisions have confirmed the steadily increase of the EC influence on bilateral treaties.⁵⁴

Christiana Panayi and Georg W. Kofler have mentioned some aspects perhaps distinguishing the *Open Skies* decisions from a case concerning tax treaties. The 'open skies agreements' dealt with air fares and computerised reservation systems, which are areas that are to a great extent covered by Community regulations. This cannot be said in the field of direct EC tax

To the extent that such agreements are not compatible with this Treaty, the Member States or States concerned shall take all appropriate steps to eliminate the incompatibilities established. Member States shall, where necessary, assist each other to this end and shall, where appropriate, adopt a common attitude.

The purpose of Article 307 EC is to make it easier for the potential Member States to become members of the Community. Dirk van Unnik and Maarten Boudesteijn argue that the provision's purpose was not to impede the existence of treaties with third countries. Van Unnik and Boudesteijn, EC Tax Review 1993/2 p.108.

⁵⁰ Hinnekens, EC Tax Review 1994/4 p.156.

⁵¹ The *Schumacker* case, C-279/93, paras.21 and 26, the *Wielockx* case, C-80/94, para.16, the *Asscher* case, C-107/94, para.36, the *Futura* case, C-250/95, para.19, Kemmeren, EC Tax Review 1997/3 p.146.

⁵² Terra and Kajus (2004) pp.27f.

⁵³ The *Open Skies* judgements are eight decisions dealing with similar topics. Cases against Denmark, C-467/98, Sweden, C-468/98, Finland, C-469/98, Belgium, C-471/98, Luxembourg, C-472/98, Austria, C-475/98, Germany, C-476/98 and a case against United Kingdom only dealing with the freedom of establishment, C-466/98.

⁵⁴ van den Hurk, EC Tax Review 2004/1 pp.1 and 25.

law, where there at the present are no complete set of common rules dealing with international tax concepts.⁵⁵

⁵⁵ Kofler, Tax Notes International 2004 p.78, Panayi, British Tax Review 2003 p.194.

3 Interaction between Community Law and Double Taxation Conventions

Some scholars are of the opinion that when Community law and tax treaties interact with each other, a possible conflict may arise.⁵⁶ As explained in chapter 2.1, the author's opinion does not coincide with that position. Naturally the two areas of law overlap each other, but there is not a 'conflict' between the systems. The effects and possible solutions of different outcomes will hereinafter be analysed.

3.1 Double Taxation Conventions and Overlapping Community Legislation

The Community legislation in the area of direct taxation is meagre. However, the few Directives that have been concluded are of a significant weight. The Directives have become a considerable source of law when combating restrictive measures of the Member States within the scope of the texts. To a certain extent the Directives restrict the Member States when concluding tax treaties with other Member States. Insofar as a DTC provision is less favourable than what Community legislation prescribes, it may not be applied.⁵⁷

The Parent-Subsidiary Directive can in certain situations overlap provisions regarding prevention of double taxation in the DTCs concluded by the Member States. In these situations EC law has solved the issue by including a specific provision relating to the hierarchy problem in the Directive. Article 7.2 states:

This Directive shall not affect the application of domestic or agreement-based provisions designed to eliminate or lessen economic double taxation of dividends, in particular provisions relating to the payment of tax credits to the recipients of dividends.

The wording is not very clear and the meaning of this provision remains obscure.⁵⁸ One question that may arise is if the Member States are allowed to introduce more favourable legislation than the Directive. Some scholars argue that the Community rules only prescribe a minimum standard.

⁵⁶ Baker (1994) p.59.

⁵⁷ van Unnik and Boudesteijn, EC Tax Review 1993/2 p.107.

⁵⁸ Baker (1994) p.59-60, Brokelind (2000) pp.355-356.

Therefore, the Member States may introduce provisions in their DTCs that go beyond what the Directive prescribes.⁵⁹

A similar article to the one mentioned in the Parent-Subsidiary Directive was included in the Interest and Royalty Directive. However, this delimitation clause declares this minimum standard more clearly. Article 9 of the Interest and Royalty Directive reads:

This Directive shall not affect the application of domestic or agreement-based provisions *which go beyond* [emphasis added] the provisions of this Directive and are designed to eliminate or mitigate the double taxation of interest and royalties.

The other direct tax Directives, which have been enacted, are likely to be complementary to the DTCs as well. This could show the intention of synchronization by the Community. It establishes legislation that is coordinated, rather than in conflict, with the bilateral tax treaties.⁶⁰

3.2 Tax Treaties and the Principles and Fundamental Freedoms of the Community

The situation becomes more difficult when it comes to the different outcome between tax treaties and the EC Treaty. An example worth mentioning in the context of this thesis is the LoB clauses, which are included in many of the Member States' DTCs. These provisions are said to have a purpose of preventing tax treaty shopping and have a similar structure as the nationality clauses, which were analysed in the *Open Skies* judgements. It is of great importance to the Member States that the receiver of the benefit has a true and genuine link to at least one of the contracting states. Certainly, this desire may result in some, to the citizens of the Union, restricting effects. Different treatment depending on the person's nationality or state of residence will occur, which is in conflict with, in particular, the freedoms of establishment and capital movement enshrined in the EC Treaty. Under these conditions the Treaty freedoms must prevail over the restricting DTC provisions. If these anti-shopping clauses may fall under some justification grounds is difficult to predict, but the Member States will probably have a complicated task in protecting their restricting provisions if they should be questioned by the ECJ.⁶¹

It ought to be mentioned that the *Open Skies* decisions did neither concern LoB clauses, nor did the provisions in the analysed agreements have taxation aspects. If this is true, why are these cases on a non-tax issue being

⁵⁹ Hinnekens, EC Tax Review 1994/4 pp.158-159 and 1995/4 pp.203 and 225, van Unnik and Boudesteijn, EC Tax Review 1993/2 p.107.

⁶⁰ Baker (1994) p.60.

⁶¹ Opinion of the Advocate General in the *Commerzbank* case, C-330/91, paras.20-23. The *Open Skies* decisions, see supra note 53. Baker (1994) pp.60-61.

brought up here? The answer is quite uncomplicated. The *Open Skies* judgements are likely to have an impact on similar tax cases concerning restrictive provisions in a DTC. Furthermore, the nationality clauses examined by the Court in the recent decisions are to a large extent similar to the LoB provisions and lead to an equivalent result when applied. Both clauses restrict the application of the treaty that they are included in to nationals of the contracting states or resident companies who are not practically owned by foreign shareholders.⁶²

How shall a tax treaty provision, which recognises the non-discrimination principles and makes a reference to Community law, be interpreted? Further, how shall a clause regulating the relationship between the tax treaty and EC law be addressed? Such provisions can be divided into four different categories according to Guglielmo Maisto. First, clauses that intend to establish the priority of EC law over the tax treaty law. Secondly, rules on the settlement of conflicts between the two sources of law. Thirdly, provisions that provide guidelines for their interpretation in the light of Community law. The fourth and last category concerns rules drafted to provide assurance of compatibility with Community law. Maisto notes that the first kinds of rules are superfluous due to the fact that the case law of the ECJ clarifies the supremacy of EC law. He also mentions that the second type of provision has little practical relevance due to the absence of conferring a solution to the problem. The rule only provides a procedure to settle a conflict. Possible violation of Community law by restrictive treaty clauses is circumvented by the guidelines of interpretation found in the provisions of the third category. Consequently, these rules are not superfluous. He also believes that the fourth category is a good means of avoiding incompatibilities with EC law.⁶³

In the light of the *Open Skies* judgements, provisions regulating the involvement of Community law should not affect the obligation of conformity with EC law. The ECJ would probably still find the treaties analysed incompatible with the fundamental freedoms if the provisions therein would have negative effects. This reasoning also has support in the principle of Community loyalty, Article 10 EC, and the earlier discussed principle of implied Community competence.

3.3 The Role of OECD and the Effect the Organisation has on EC Law

The OECD Model Tax Convention is often regarded as an instrument for codifying international tax law.⁶⁴ A dilemma of an inconsistent application of the Model Convention may arise due to the method that the Organisation uses when introducing new standards. Because of the numerous treaties and the difficulty in changing all of them, the OECD tends to rewrite the

⁶² De Ceulaer, Bulletin 2003 p.494.

⁶³ Maisto, European Taxation 2002 pp.304ff.

⁶⁴ The *Schumacker* case, C-279/93 para.32 and the *De Groot* case, C-385/00 para.98.

Commentary instead of the Model itself. In many, and maybe most, countries the national Courts will not take into account the changes that have been made in the Commentary when interpreting a treaty.⁶⁵ Although the Model Convention is used to codify international tax law, some of its provisions may be incompatible with EC law. In spite of this, can rights and obligations be derived from the OECD Model Tax Convention and is the Community bound by the Model's guidance when analysing a bilateral tax treaty potentially in conflict with EC law?

The European Community is not a member of the OECD, but participates to a certain extent as a Permanent Delegation. The involvement goes beyond a mere observer and the Community can be seen as a quasi-member. However, the representatives of the Community cannot express reservations to the OECD suggested texts and are not entitled to vote when legal acts are being adopted. What the Community is entitled to do is to make proposals and suggest changes during the preparation of legal acts.⁶⁶

Article 304 EC states that the Community shall establish a close co-operation with the OECD. The recommendations given by the Organisation, of how its members shall draft and apply their bilateral treaties, cannot be seen as compulsory. The Model Tax Convention is only a set of recommendations and the Community's effort in establishing a close co-operation shall not be misunderstood as an obligation to follow the Organisation's advices.

The ECJ often comes to the same conclusion as prescribed by the OECD Model Tax Convention. However, there is nothing in the Court's case law that indicates some kind of obligation to follow the Organisation's recommendations. On the contrary, the ECJ has declared provisions incompatible with EC law, which at the same time were in compliance with the OECD Model Tax Convention.⁶⁷

3.4 Suggested Paths to Solve Different Outcomes when Applying Tax Treaties and European Law

Articles 293 and 307 EC require the Member States to co-ordinate their tax treaties. If this effort is not encouraged by the States, the Community can always achieve such result through the ECJ. The Court shall ensure the interpretation and *application* of the EC Treaty, Article 220 EC. This work by the ECJ can be seen as negative integration and such adjustments are

⁶⁵ Avery Jones, EC Tax Review 1998/2 p.98.

⁶⁶ http://www.oecd.org/about/0,2337,en_33873108_33873325_1_1_1_1_1,00.html, Hinnekens, EC Tax Review 1994/4 p.165.

⁶⁷ The *Lankhorst-Hohorst* case, C-324/00 paras.39 and 44. The Advocate General points out in his opinion paras.79-82, that neither the provisions nor the objectives of the OECD Model Convention, on the one hand, or of the EC Treaty, on the other, are in fact the same.

never completely satisfactory.⁶⁸ The only way for the Member States to influence the development in this area, is to engage in negotiations with the other Member States and the Community with the purpose of reaching a common solution. This effort to undertake an assignment of positive integration can lead to many different results.⁶⁹ The author will here shortly mention some debated alternatives to counteract the potentially troublesome interaction between tax treaties and Community law. If these proposed solutions are optimal and realistic is not going to be discussed thoroughly in this thesis.

One frequently discussed solution in international tax literature is an EU Multilateral Tax Treaty between all the Member States. The document should replace all the existing DTCs among the Member States. The Treaty would be based on the OECD Model Tax Convention and must be seen as an effort to engage in tax co-ordination rather than harmonisation in the tax field. The Treaty can address problems which bilateral tax treaties cannot do. This creates an improved legal certainty and reduces complexity. Bilateral tax treaties can no longer be considered as an appropriate method of creating common market conditions. Article 293 EC was drafted more than 40 years ago and must nowadays be given a different and more critical approach. Moreover, a strict interpretation of Article 293 EC requires that the Member States come to multilateral solutions. The competence of the Member States to conclude and negotiate bilateral tax treaties is only residual according to this argument. Only a Multilateral Tax Treaty can achieve the goal of creating common market conditions according to Otmar Thömmes.⁷⁰

Another solution advocating tax co-ordination is the idea to introduce an EU Model Tax Convention, which would follow most of the rules in the OECD Model. The Member States would be obliged to implement the Model in their bilateral tax treaties after they have signed the document. Situations not regulated by the EU Model could remain unaltered in the bilateral tax treaties between the Member States. The Model would have a similar structure to an EU Directive, due to the fact that the provisions could be more or less specific in their way of describing the compatibility with Community law. An advantage of this long-term approach is that it leaves some room for the States to continue to reflect strictly bilateral concerns in their DTCs.⁷¹

Under the MFN doctrine, which also has been put forward as a potential key to solve the problem, a State has to ensure the best treatment applicable to all the Countries which it has relations with and where it has recognised this

⁶⁸ Pistone, EC Tax Review 2005/1 p.4.

⁶⁹ Pistone, EC Tax Review 2002/3 p.129.

⁷⁰ De Ceulaer, Bulletin 2003 p.502, Maisto, European Taxation 2002 pp.303ff, Pistone, EC Tax Review 2002/3 p.132 and EC Tax Review 2005/1 p.6, Rädler, Intertax 2004/8/9 p.369, Thömmes, CFE Forum 2005 p.7.

⁷¹ De Ceulaer, Bulletin 2003 pp.501f, Kemmeren, EC Tax Review 1997/3 p.151, Maisto, European Taxation 2002 pp.303ff, Pistone, EC Tax Review 2002/3 pp.132f and 136 and EC Tax Review 2005/1 p.6.

entitlement. This treatment is neither recognised by the EC Treaty nor found in the case law of the ECJ, but could easily be achieved through intervention by the Court if it finds this evolution necessary. This judicial application of the MFN principle is not an adequate solution according to some scholars.⁷² Others support the applicability of the doctrine. This debate is further discussed in the following chapter and will therefore temporarily be left aside. Though, something worth mentioning here is that the introduction of a MFN treatment can influence the Member States to take action. If the States are not supporting the development created by the ECJ, they must cooperate with each other in some way. By welcoming a common solution, the Member States can participate and influence the tax evolution in this field.

This voluntary approach by the Member States has some similarities with Article 293 EC. The Article requires, as mentioned above, that the Member States enter into negotiations with each other with the aim of preventing double taxation within the Community. This alternative can also be called the purely international solution and is based on this specific Article. Another method, which has been put forward in tax literature, could be the purely Community law solution, which is based on Article 94 EC and favours the introduction of supranational legislation through a Directive. Lastly the strengthening of source taxation could be mentioned in this context as a way of solving interaction problems between different sources of law.⁷³

⁷² Pistone, (2002) pp.207-213 and EC Tax Review 2002/3 pp.130f. See further spokesmen in chapter 4.3.2.

⁷³ Pistone, (2002) p.207 and EC Tax Review 2002/3 pp.131f.

4 Most-Favoured-Nation Treatment

Globalization and Europeanization are two trends emerging from the twentieth century. The deep-rooted frontiers are losing their importance in the new world. The global trends also have consequences on the tax borders. Many questions exist in the academic area regarding this change and several ideas of possible ways to develop taxation are invented here as well. A debated field at the present time is if a MFN treatment will apply to the tax provisions in DTCs within the Union and perhaps even in relation to third countries.⁷⁴

It is not yet clarified if a MFN principle does bind Member States when applying their double taxation conventions. The ECJ has avoided the problem by not addressing it in its rulings. Nevertheless, this situation may change. At the present there are three cases pending⁷⁵ where the Court could choose to finally clarify a much debated question. However, before analysing the future development of the MFN principle in direct EC tax law, a historical retrospection could be appropriate.

4.1 Development of the Principle in General

The MFN standard has a long history. It has been applied in both investment and trade law for a considerable period of time. Usually the principle also can be found in areas of foreign exchange, intellectual property and diplomatic immunities.⁷⁶ Although there is a wide range of this obligation nowadays, the principle has traditionally been associated to trade agreements.

The first example of a provision with MFN consequences was introduced in a treaty signed on 17 August 1417 between King Henry V of England and the Duke of Flanders concerning harbour access. In the seventeenth century the MFN principle was no longer limited to specific states, but to *any* other third country. Already in 1860 the first 'modern' trade treaty was concluded and in 1929 the Council of the League of Nations adopted a model MFN clause in respect of tariffs. A classical unconditional MFN principle was introduced in the 1947 GATT.⁷⁷ It is nowadays found in Article I of the 1994 GATT, where it states that any advantage, favour, privilege or immunity granted by a Member to any product originating in or destined for

⁷⁴ Rädler, Intertax 2004/8/9 p.365.

⁷⁵ Case C-376/03, the 'D' case, case C-8/04, the *Bujura* case and case C-374/04, the *ACT Test Claimants* case.

⁷⁶ UNCTAD Series 1999 pp.3 and 5.

⁷⁷ *Idem* p.13.

any other country shall be accorded immediately and unconditionally regarding that product to all other contracting parties. Consequently, there must be an *advantage*, the products must be *similar*⁷⁸, the treatment shall be *unconditional* and granted within a *time limit*. The objective of this obligation is to ensure equality aspects in trade between WTO Members.⁷⁹ It is important to note that the MFN principle applies to all sorts of rules, according to Wolfgang Schön. ‘Hence, it is not limited to customs duties, but also applies to indirect and direct taxes to the extent they distinguish between products based on the country of origin’.⁸⁰

The MFN doctrine has been a core element of international investment agreements for decades and became a common feature in the 1950s. In the field of investments the standard means that a host country must give a foreign investor the same favourable treatment as it offers to its own citizens. This creates a guarantee against certain forms of discrimination on grounds of nationality and is of an utmost importance for the establishment of equal competitiveness within the states.⁸¹

There are some exceptions to the MFN obligation in trade law and in bilateral investment treaties. Most treaties allow contracting parties to derogate from the non-discrimination standard when it is found necessary. There are several general exceptions⁸² for instance, national security reasons and also more specific exceptions based on reciprocity aspects especially in the area of taxation. Individual country-specific exceptions can also be found in the treaties. All investment agreements dealing with taxation issues exclude these matters from the applicability of the MFN standard. The bilateral tax treaties are founded on a mutual sacrifice where the states waive their taxation rights. A unilateral waiver to any third state has not been generally accepted in the investment field.⁸³

The MFN principle corresponds in both the area of trade and investment to the principle of national treatment. The national treatment standard can be described as a principle of non-discrimination. In trade law it is found in Article III of the 1994 GATT. When the products are *inside* the Union this principle applies according to this Article. The principle included in GATT can be compared with Article 90 EC, which states that internal taxation should not be used as a means of discrimination against foreign products from other Member States. National treatment is also of importance in the investment field as a supplement to the MFN standard. Exceptions in the international investment agreements to national treatment rules are more

⁷⁸ This is called the *ejusdem generis* principle. The meaning of this interpretation method is that only certain matters belonging to the same subject matter, category or class of matter as the MFN provision can benefit from the clause. Sutton, *Arbitration International* 2005 p.119.

⁷⁹ GATT is now a part of the WTO Agreement.

⁸⁰ Schön, *Bulletin* 2004 p.287.

⁸¹ UNCTAD Series 1999 pp.1 and 13.

⁸² For instance ‘enabling clauses’ i.e. developing countries are include here, protection of public order, health and moral, Article XX, security motives, Article XXI.

⁸³ UNCTAD Series 1999 pp.1, 7f and 15ff.

frequent than exceptions to MFN provisions. Furthermore, a question of hierarchy can arise between the two principles. Which treatment prevails if a foreign investor can claim both national and MFN treatment? Sometimes the actual treaty has answered this question by including an explicit rule in this respect. In other situations where this is not regulated, the answer is uncertain. Another difficult issue is whether a 'pick-and-choose' strategy should be allowed, i.e. if the investors should be permitted to choose the best mixture of the two standards to receive the most benefiting result in the end.⁸⁴

This short and not in any way exhaustive review of the purpose and development of the MFN standard may be of assistance for the understanding of the principle's possible application in direct EC tax law.

4.2 Does the Non-Discrimination Principle Imply a Most-Favoured-Nation Treatment?

The ECJ has the opportunity once and for all to take a position on the issue of a potential judicial application of the MFN doctrine in direct tax law when deciding the two related '*D*' and *Bujura* cases. Dutch courts referred both cases to the ECJ and the preliminary questions indicate a comparison between the tax treatment of non-resident taxpayers from different Member States, i.e. a matter of possible horizontal discrimination. It is up to the Court to decide if such a comparison lies within the non-discrimination rule in EC law.⁸⁵ If the Court does not find that horizontal discrimination is at hand in the two linked cases, it still has a possibility to make a new analysis in the more recent referred *ACT Test Claimants* case.⁸⁶

The '*D*' case concerns the Dutch net wealth tax treatment of a German national who holds 10 per cent of his taxable property in the Netherlands. The Dutch net wealth tax legislation entitles a tax-free allowance to non-residents only if at least 90 per cent of their wealth is located in the Netherlands. The Dutch tax treaty with Belgium includes a provision according to which Belgian taxpayers are entitled to the same allowance as Dutch resident taxpayers. Another aspect worth mentioning is that in 1998 neither Germany nor Belgium levied that kind of tax, which put residents in those countries on the same footing regarding the net wealth tax levied in the Netherlands. Unlike the 1970 Netherlands-Belgium Tax Convention, the Germany-Netherlands treaty concluded in 1959 entitled the Netherlands to

⁸⁴ UNCTAD Series 1999 pp.30-32.

⁸⁵ Opinion of Advocate General Ruiz-Jarabo Colomer in the case C-376/03, the '*D*' case, reference for a preliminary ruling in case C-8/04, the *Bujura* case, O.J. 6.3.2004 C59 p.17, Meussen, European Taxation 2005 pp.52ff, Schnitger, Internationales Steuerrecht 22/2004 pp.801f, Thömmes, Intertax 2005/1 p.44, van der Linde, EC Tax Review 2004/1 pp.10ff, Weber and Spierts, European Taxation 2004 pp.65ff.

⁸⁶ Reference for a preliminary ruling in case C-374/04, the *ACT Test Claimants* case, O.J. 6.11.2004 C273 pp.17f.

levy net wealth tax on immovable property in that state. The Dutch Gerechtshof Herzogenbusch submitted the case to the ECJ for settlement of the net wealth tax treatment's conformity with the free movement of capital, Article 56 EC. The case is still pending, but the Advocate General Colomer submitted his opinion on 26 October 2004. The Advocate General recommended that the Court should find the treatment incompatible with the freedom of capital movement. However, he suggested that the Court should not give a ruling on the MFN issue.⁸⁷

Three preliminary questions were put forward to the Court in the dispute whether D as a non-resident has the right to deduct the basic allowance normally granted to resident taxpayers. Primarily, the ECJ needs to address if there is a possible discrimination between residents and non-residents. D requests to be equally treated as a Dutch resident taxpayer, due to the fact that the two are in the same situation. The alternative position taken by D, if he is in an objectively different situation as compared to a resident taxpayer, is that the MFN treatment is available. Lastly, the aspect of possible compensation of actual legal costs is being analysed by the Court. The third question will be left aside in this case examination.⁸⁸ The Advocate General is of the opinion that the Dutch rules are contrary to the free movement of capital according to the first preliminary question. Consequently, no examination of the MFN treatment needs to be done according to him.⁸⁹

Gerard Meussen does not agree with the Opinion of the Advocate General relating to the issue of equal treatment. The Advocate General appears to give the fact that Germany does not levy any net wealth tax too much significance in the assessment of whether the two different taxpayers are in a comparable situation or not. Meussen points out that the Netherlands should not be forced to grant a basic tax-free allowance to a German resident taxpayer because Germany omits to levy net wealth tax *at all*. The EC Treaty does not oblige the Member States to harmonise their taxes in the direct tax field.⁹⁰

The further argumentation of the Advocate General is not clear. Even if he is against the application of a MFN principle, he suggests that if the Court would give a ruling on the issue it should do so in line with his Opinion,

⁸⁷ Opinion of Advocate General Ruiz-Jarabo Colomer in the case C-376/03, the 'D' case.

⁸⁸ Meussen has commented on this preliminary question in *European Taxation* 2005 p.55. He is of the opinion that a limitation on refund of legal costs is in violation with the EC Treaty and a great hindrance in bringing a case before court. This argumentation is in line with the Advocate General, Opinion of the Advocate General in the 'D' case, C-376/03 paras.107-112.

⁸⁹ Opinion of the Advocate General in the 'D' case, C-376/03 para.71. Van der Linde is of the opinion that this question should be answered in the affirmative and hence D should be granted a tax-free allowance as indicated by the MFN principle, van der Linde *EC Tax Review* 2004/1 p.16.

⁹⁰ Meussen, *European Taxation* 2005 pp.53f. The opinion that the first preliminary question should be answered in the affirmative is not undisputed. Van der Linde expresses the belief that the situation of D and a resident taxpayer is not to be considered as similar, van der Linde *EC Tax Review* 2004/1 p.16.

which is surprisingly well developed.⁹¹ The MFN principle does not appear to be automatically transferable to the case. However, he suggests that on the basis that the various non-residents are in the same situation, the different treatment by the Netherlands is a *restriction* of Article 56 EC and nothing else. Consequently, the Advocate General invites the Court to rule on the basis of national treatment and that this treatment is not available to the German national.⁹² By giving in to this reasoning, the Court will find a solution to the present case in the EC Treaty. This outcome could be seen as a wide interpretation of Article 12 EC. The non-discrimination principle found in that Article precludes *any* discrimination on grounds of nationality. The prerequisite 'any' indicates a broad application. This interpretation acknowledges a comparison between two non-residents, namely examines a possible horizontal discrimination.

This reasoning of the Advocate General leads inevitably to some questions regarding the scope of the MFN doctrine. Can the MFN treatment be described as another type of non-discrimination principle enshrined in Article 12 EC? With this interpretation the MFN principle has support in the EC Treaty. By virtue of the non-discrimination principle, the MFN treatment would not be given a general application. The Member States can still claim that the treatment is objectively justified according to ordinary justification grounds found in the EC Treaty or supported by the rule of reason doctrine. Frans Vanistendael is a critical believer of the MFN doctrine and considers that the MFN standard has a place in direct EC tax law. However, he is not of the opinion that the principle should be applied in a general unconditional manner. Every situation needs to be examined according to the specific facts given in the certain case.⁹³ The question still remains if the two non-resident taxpayers are in an objectively similar situation or not. A general application of the MFN standard may be avoided by this kind of examination.

There is a support for the broad interpretation of Article 12 EC and its 'any' prerequisite. The non-discrimination principle is not restricted to the conduct of another Member State. Consequently, we have a situation where the States neither are allowed to discriminate nationals of another Member State nor its own nationals, reverse discrimination⁹⁴. Therefore, discrimination between foreigners with citizenship of the Union, Article 17 EC, must also be prohibited. Weber and Spierts have declared that 'Belgian residents, as well as German residents, are, for the application of Community law, in the same situation'.⁹⁵

⁹¹ Opinion of the Advocate General in the 'D' case, C-376/03 para.106.

⁹² *Idem* paras.95-97, Pistone, EC Tax Review 2005/1 p.5.

⁹³ Seminar on the recent case law of the European Court of Justice, Katholieke Universiteit Leuven 2005-02-26.

⁹⁴ Reverse discrimination is prohibited, see the *D'Hoop* case from 2002, C-224/98. This case concerned the freedom of movement for workers within the Union.

⁹⁵ Weber and Spierts, European Taxation 2004 p.68.

Gerard Meussen has some interesting remarks regarding the Advocate General's reply to the second preliminary question in the 'D' case, in other words, the possible MFN treatment. Initially, Meussen points out certain aspects in the DTC between Belgium and the Netherlands. The Advocate General remarks that the treaty provision, which provides for a tax-free allowance in respect of the net wealth tax, is a privilege granted without reciprocity. Belgium does not levy a net wealth tax and consequently it seems to be a very generous gift from the Netherlands without any favours given in return. This fact should most certainly raise one's eyebrows. If the author has understood professor Meussen correctly, then he wants to point out that it is dangerous to isolate one provision in a bilateral treaty. It is important to recognize that the whole tax treaty is a result of a give and take. Why should the Netherlands unilaterally grant this favour with no benefits in return? He moreover imagines that the ECJ is going to find the MFN doctrine applicable in the 'D' case. Discrimination of this kind cannot be allowed under the EC Treaty in this specific case. However, a general application of the MFN principle is not desirable.⁹⁶

In the *Bujura* case the circumstances are similar to the 'D' case. A German national insists of being equally treated as a Belgian taxpayer in the Netherlands. The Netherlands has repealed its former legislation on wealth tax, and instead charges income tax on income from savings and investments.⁹⁷ The Dutch tax-free allowance and tax credit for income tax in the calculation of the income from savings and investments are intended for resident taxpayers or non-residents with at least 90 per cent of their income in the Netherlands. Unlike the Netherlands-Germany Tax Convention, the Netherlands-Belgium Tax Convention does not have this percentage requirement.⁹⁸ The Opinion of the Advocate General in this case has not yet been delivered, but is expected shortly.

4.3 Community Most-Favoured-Nation Treatment Limited to a Purely EU Perspective

The absence of a MFN provision has not been exceptionally burdensome for the concerned parties in the indirect tax field. The loss of problems is achieved by the customs union and by the fact that the excise taxes have been harmonised to a large extent.⁹⁹ However, this type of co-operation has not been accomplished in the direct tax field. The ECJ has had the opportunity to give its opinion to the MFN doctrine in direct EC tax law in the joined cases *Metallgesellschaft and Hoechst*¹⁰⁰. The problem was brought up to the Court's attention by the referring judge, but the ECJ did

⁹⁶ Meussen, *European Taxation* 2005 pp.54f.

⁹⁷ Lyal, *CFE Forum* 2005 p.4.

⁹⁸ Reference for a preliminary ruling in case C-8/04, O.J. 6.3.2004 C59 p.17.

⁹⁹ Schön, *Bulletin* 2004 p.284.

¹⁰⁰ Judgement of the Court of 8 March 2001, Joined Cases C-397/98 and C-410/98, *Terra and Wattel* (2001) pp.96f.

not address this issue. In the *Schumacker* case the Court did not need to address this matter although similar problems arose in that decision.¹⁰¹ Even though no position was taken at the Community level, it put life into the academic debate concerning the MFN treatment in direct EC tax law.

4.3.1 Main Arguments of the ‘Believers’

The believers often seem to argue that the nationals of the Member States in the first instance are citizens of the Union. The attempt to draw a distinction between people residing in different Member States in national provisions is of no importance. Every person holding the nationality of a Member State has a citizenship of the Union. This citizen shall be equally treated independently of his nationality, Article 17 EC. One of the objectives of the Community is to achieve a level playing field and the believers are of the opinion that the MFN standard would ease this approach.¹⁰² Clearly, there is no general principle in the EC Treaty that requires an implementation of a full MFN principle in the tax treaties of the Member States. Article 293 EC is a provision which illustrates that this is not the intention. Then again, the bilateral tax treaties must comply with Community law, especially the fundamental freedoms.¹⁰³

One argument put forward by the believers is that the MFN treatment in essence is just another classification of a form of discrimination based on nationality. The sole difference between the MFN approach and the traditional standard is the comparative element in the MFN evaluation. The prohibition of discrimination based on nationality should therefore also apply in these cases. Based on the wording of Article 12 EC and the prerequisite ‘any’ this horizontal discrimination should fall within the scope of the EC Treaty.¹⁰⁴ The provision is drafted in the most general terms without specific reference to discrimination against nationals of other Member States. In these situations the purpose of the EC Treaty has a decisive influence of the interpretation of the non-discrimination principle according to the teleological interpretation method, which is commonly used by the ECJ. The fundamental principles found in the EC Treaty should be interpreted broadly rather than restrictively.¹⁰⁵

4.3.2 Main Arguments of the ‘Unbelievers’

The unbelievers have expressed the opinion that a general application of the MFN standard will lead to negative consequences. A ‘pick-and-choose’ strategy put to use by the taxpayers is an example of such negative outcomes. The MFN principle would undermine the Member State’s sovereignty and bargaining power in the direct tax field and lead to erosion in tax proceeds. It could also result in free-rider problems. These unintended

¹⁰¹ Weber and Spierts, *European Taxation* 2004 p.67.

¹⁰² Rädler, *EC Tax Review* 1995/2 p.67, van der Linde, *EC Tax Review* 2004/1 p.12.

¹⁰³ Rädler, *EC Tax Review* 1995/2 pp.66f.

¹⁰⁴ De Ceulaer, *Bulletin* 2003 p.495, van der Linde, *EC Tax Review* 2004/1 pp.12f.

¹⁰⁵ De Ceulaer, *Bulletin* 2003 p.496, Hinnekens, *EC Tax Review* 1995/4 p.207.

and maybe unforeseen consequences have influenced the unbelievers in their judgement. Some of the believers are not convinced that this predicted 'chaos' would occur.¹⁰⁶

Eric Kemmeren, who characterizes himself as 'more than a critical non-believer', considers the MFN issue already decided in the *Bachmann* case¹⁰⁷. *Bachmann* had moved to Belgium, but was still paying insurance contributions to a German insurance company. These contributions were not deductible under Belgian law, due to fact that the payment was made to a non-resident company. *Bachmann* put forward that the non-deductibility was discriminatory. Contributions to insurance companies resident in France, Luxembourg or the Netherlands were deductible according to Belgian agreements with those countries.¹⁰⁸ In the ruling the ECJ did not take the MFN principle into consideration and Kemmeren points out that the treatment can only be available if a MFN clause is included in a DTC or in co-ordination or harmonisation measures from the Council.¹⁰⁹ Nevertheless, it is hard to draw any conclusions from this judgement of the ECJ.¹¹⁰

4.4 Community Most-Favoured-Nation Treatment Beyond the Purely EU Point of View

There can be a distinction made between two different sets of application of the MFN treatment in EC tax law. The earlier mentioned arguments relate to a purely Community level. This section will address the MFN principle from another perspective, the treatment beyond the borders of the Union. Namely, does the MFN treatment oblige a Member State to apply the same favourable standard to nationals of other Member States, as it does towards nationals of a third country? This means that tax treaties concluded with third countries come into play when analysing these situations.

The Community principle of free movement of capital includes a 'reversed' MFN standard, that is to say, a MFN treatment towards third countries. This

¹⁰⁶ Avery Jones, EC Tax Review 1998/2 p.97, De Ceulaer, Bulletin 2003 p.496f, Dourado, EC Tax Review 2002/3 pp.151ff and 156, Hinnekens, EC Tax Review 1994/4 pp.152ff and EC Tax Review 1995/4 pp.210ff, Terra and Wattel (2001) p.97, van der Linde, EC Tax Review 2004/1 pp.12 and 17, Vogel, EC Tax Review 1995/4 pp.264f.

¹⁰⁷ Judgement of the Court of 28 January 1992, Case C-204/90 para.26:

It is true that bilateral conventions exist between certain Member States, allowing the deduction for tax purposes of contributions paid in a contracting State other than that in which the advantage is granted, and recognizing the power of a single State to tax sums payable by insurers under the contracts concluded with them. However, such a solution is possible *only* [emphasis added] by means of such conventions or by the adoption by the Council of the necessary coordination or harmonization measures.

¹⁰⁸ Opinion of the Advocate General in the *Bachmann* case, C-204/90 para.27.

¹⁰⁹ Seminar on recent case law of the ECJ, Katholieke Universiteit Leuven 2005-02-26, Kemmeren, EC Tax Review 1997/3 pp.146ff and 152.

¹¹⁰ De Ceulaer, Bulletin 2003 p.496f.

means that at the present the MFN principle has some kind of support in the EC Treaty, or to be more exact in Article 56 EC. The Article requires a Member State to grant the same favourable national standard to persons from third countries. This is however not the same as extending benefits granted to third country residents to other citizens of the Union.

The *Halliburton* case¹¹¹ gives an indication that the ECJ reads a MFN obligation into the EC Treaty. In this tax case the Court apparently thought it was important to notice that a company located in a third country had been granted a more favourable tax treatment than the company residing in one of the Member States had been. The organisation residing within the Union was denied a tax benefit, which at the same time was granted the company from the third country. These considerations seem to have indirectly influenced the Court in its decision according to Stefaan De Ceulaer.¹¹²

The *Gottardo* decision¹¹³ is a case where the ECJ examined a bilateral convention in the social security field concluded between a Member State, Italy, and a third country, Switzerland. Mrs Gottardo was a French national and consequently not entitled to the benefits of the treaty. The difference in treatment depended solely on Mrs Gottardo's nationality.¹¹⁴ The Court demanded equal treatment towards nationals of other Member States. The same advantages received under the bilateral convention by the Italian nationals should also be granted to citizens of the Union in general according to the fundamental freedoms enshrined in the EC Treaty.¹¹⁵ There is at the moment no case law indicating such an obligation in the income tax field. However, this ruling has been mentioned in the context of extending the MFN treatment to this area.¹¹⁶

The *Open Skies* cases and the above-mentioned ones may have an impact on the further development of the MFN treatment in DTCs concluded with third countries. The *Open Skies* decisions are resulting in a Member State obligation to confer the same air transport rights on other Member States as the contracting state does towards a third state. This is the opinion of Stefaan De Ceulaer, who also points out the striking similarity of the issues, due to the fact that all the cases are dealing with 'non-garden Community MFN Treatment'. In other words, they relate to MFN treatment beyond a purely EU perspective.¹¹⁷

Gerard Meussen is reluctant to see that the MFN treatment should be granted in relation to third states. 'This would paralyse the Member States in negotiating a bilateral tax treaty, as they would feel the eyes of the other 23

¹¹¹ Judgement of the Court of 12 April 1994, Case C-1/93.

¹¹² De Ceulaer, Bulletin 2003 p.497.

¹¹³ Judgement of the Court of 15 January 2002, Case C-55/00.

¹¹⁴ *Idem* paras.23-24.

¹¹⁵ *Idem* paras.32-34.

¹¹⁶ De Ceulaer, Bulletin 2003 p.497.

¹¹⁷ *Ibid.*

Member States on their backs or sense that all of the other Member States were looking over their shoulders trying to ascertain what was being negotiated.’¹¹⁸

4.5 Implications on Direct Tax Law

There is not a total absence of the MFN principle in tax treaty law. Some tax treaties do actually contain a MFN clause. These benefits are for instance given in the relations with former colonies, for purposes of stimulating their economic development and also in the relations between mutually dependent economies like Canada and the United States. Apart from these exceptions, the bilateral tax treaties do not address the MFN issue.¹¹⁹ The Commission once answered a parliamentary question regarding the application of the MFN treatment in the negative. Community law did not oblige the Member States to automatically grant the most favourable withholding tax rate in a bilateral treaty to taxpayers of other Member States.¹²⁰ However, the Commission recognised in a Communication from 2003 the importance of a thorough examination of whether some form of MFN clause between the Member States might be necessary in the future.¹²¹

According to the ECJ, there is no discrimination and consequently no need for a MFN treatment if the DTC provisions merely provide for an allocation of taxation rights. The Member States are competent to decide the allocation criteria in their bilateral tax treaties when working against double taxation, the second indent of Article 293 EC. These criteria are not incompatible with the EC Treaty, not even if the specific provision uses the nationality of the taxpayer as a decisive criterion. Since Community law has not determined any connecting factors for the purpose of tax allocation, the Member States are still allowed to do so.¹²² The difficult task at this point is to decide whether a provision only provides for an allocation of taxation rights. For instance, is a rule that sets a certain maximum withholding tax percentage on income just a provision of tax allocation? Some scholars are of the opinion that such clauses are not merely providing allocation standards, but are unilateral measures of a country. In these situations the MFN principle should be applicable if it is deemed as another type of non-discrimination principle. Other clauses in a DTC that not only provide tax allocation, but which also constitute tax benefits, are provisions leading to an exemption, a deduction or a tax-free allowance. These certain rules are not eliminating double taxation, but are just a reduction of a singular taxation in one Member State. These kinds of rules are not mentioned in Article 293 EC and must therefore respect the non-discrimination

¹¹⁸ Meussen, *European Taxation* 2005 p.54.

¹¹⁹ Pistone (2002) pp.208f.

¹²⁰ Written Answer, November 9, 1992, Question No.647/92, O.J. C40 15/02/1993 p.13.

¹²¹ COM (2003) 726 final p.11.

¹²² The *Gilly* case, C-336/96 para.30, the *Saint-Gobain* case, C-307/97 para.56, Hinnekens, *EC Tax Review* 2002/3 p.115, van der Linde, *EC Tax Review* 2004/1 p.14, Weber, *CFE Forum* 2005 pp.1f, Weber and Spierts, *European Taxation* 2004 p.68.

principle.¹²³ According to Dennis Weber provisions not allocating tax jurisdiction do not belong in DTCs. If the ECJ follows the Opinion of the Advocate General in the 'D' case, such provisions have to be removed from the tax treaties. Only provisions that allocate the taxing rights between the contracting parties with the aim of preventing double or non-taxation can be allowed.¹²⁴

Van der Linde believes that the EC Treaty imposes a MFN treatment, but with the limitation that the disputed DTC provisions go beyond mere allocation of taxation rights. Provisions with a maximum withholding tax percentage on dividends, interest and royalties are not subject to the MFN principle. This on the assumption that the power to determine the criteria for the allocation of taxation rights lies with the Member State and that the Community has not engaged in any unifying measures in the field. Moreover, he points out that the traditional national treatment must be applied in first instance and thereafter, if necessary, a possible MFN treatment will be analysed.¹²⁵

Weber and Spierts express the opinion that even if the authority to determine the allocation criteria still lies with the Member States, these factors cannot be applied contrary to the principles in Community law. The right of the Member States to determine these criteria must not be confused with the obligation to comply with Community law in general. The ECJ has explicitly pointed this out in its *De Groot* decision.¹²⁶

The MFN treatment does not take into consideration the principle of reciprocity. This principle is of great importance for the States when concluding a DTC. In other words it can be explained as a process of give and take among the parties. The principle of reciprocity has been brought up as a justification ground by the national Governments in cases before the ECJ. However, the Court has not accepted it as a legitimate reason to justify the discriminatory effects in the treaties, although it constitutes an objective justification. In the *Saint-Gobain* and *Gottardo* decisions the ECJ did not see how the balance and reciprocity of the bilateral treaties concluded between the parties could be disturbed. These both rulings relate to bilateral agreements, each concluded by a Member State and a non-Member country. If the ECJ would come to another judgement concerning bilateral treaties exclusively concluded by Member States is not clear. The outcome would probably be the same if the balance of the DTCs were undisturbed in these cases too.¹²⁷

¹²³ van der Linde, EC Tax Review 2004/1 p.14f.

¹²⁴ Weber, CFE Forum 2005 p.3.

¹²⁵ van der Linde, EC Tax Review 2004/1 p.16f.

¹²⁶ The *De Groot* case, C-385/00 para.94, Weber and Spierts, European Taxation 2004 p.68f.

¹²⁷ Weber and Spierts, European Taxation 2004 p.69.

5 Different Limitation on Benefits Clauses and Frequently Used Qualification Tests

Bilateral tax treaties often contain clauses with the purpose of preventing certain types of abuse of the actual international agreement. These anti-treaty abuse articles are also known as anti-treaty shopping or LoB provisions. The anti-treaty shopping provisions are all drafted differently and the OECD, which has a purpose of setting an international standard to bilateral treaties, has not included a LoB clause in its Model Convention. Nevertheless, the inherent purpose, which is supported by the OECD, is the same in each of these clauses.¹²⁸ The provisions have an aim of counteracting abuse, by only extending benefits to parties with a real business purpose or a sufficiently strong nexus to one of the contracting states. When discussing and analysing these clauses, it finally arises a question of compatibility with Community law or to be more precise, a question of possible violation of Community loyalty or infringement of the fundamental freedoms. Regularly the restrictions are analysed in the light of the freedoms of establishment and capital movement.¹²⁹

For quite a long period of time many Member States concluded several bilateral treaties with the United States. They often include anti-shopping provisions that deny the treaty favours to companies owned by residents of third countries.¹³⁰ One of these treaties is the DTC concluded between the Netherlands and the United States. The thesis will ultimately focus on this treaty from 1992 and its amending protocol from 2004. The 1992 DTC was actually the first tax treaty concluded by the United States that explicitly recognised the existence and significance of the European Community.¹³¹

The United States and the Netherlands signed a protocol on 8 March 2004 that made the 1992 income tax treaty more compatible with the Netherlands

¹²⁸ However, the Commentaries to the OECD Model Convention approve of the use of anti-abuse clauses and contained for the first time in the version from 2003 an example of a detailed LoB provision, Article 1 paras.19-20. LoB clauses are a more appropriate means to counteract treaty abuse than narrowing the concept of residence in Article 4 of the Model Tax Convention. Changing the concept of residence is not an effective approach to prevent abuse according to the OECD. This could damage the position of the persons who are rightfully entitled to treaty benefits, OECD 2002 Reports No.8 p.10. Hinnekens, EC Tax Review 1995/4 p.226, Kofler, Tax Notes International p.47.

¹²⁹ Kofler, Tax Notes International 2004 pp.46, 49, Pistone (2002) p.91, Terra and Wattel (2001) p.113.

¹³⁰ Baker (1994) p.60, Kofler, Tax Notes International 2004 p.48.

¹³¹ However, Dirk van Unnik and Maarten Boudesteijn remark that the practical significance of this recognition should not be overstated, van Unnik and Boudesteijn, EC Tax Review 1993/2 p.111.

obligations under EC law. One of the reasons behind the amending protocol was actually the old and probably discriminatory LoB clause.¹³² The new LoB article has generally expanded its reach, but is at the same time shorter than its forerunner. Nonetheless, the new provision is still one of the largest LoB articles known. A new *substantial presence* test¹³³ is added to the several qualification tests provided by the clause and the *derivative benefits* test¹³⁴ has been amended. Both these tests will be described in detail below. The protocol made other important changes to the tax treaty and has been effective since 1 January 2005 and in respect to withholding taxes, 1 February 2005.¹³⁵

This review has the purpose of presenting common solutions found in international bilateral tax treaties, rather than to restate all the detailed criteria in the LoB articles. The agreement between the United States and the Netherlands has an enormous set of qualification tests in its LoB clause, which is found in Article 26 of the tax treaty. The author limits the study to this recently signed agreement and its LoB article. There are many conditions that need to be fulfilled and here the qualification tests will be described broadly with the aim of presenting the most important features.¹³⁶

In order to ensure that only genuine residents favour, rather than ‘conduit companies’ not residing in one of the contracting states, the LoB provisions contain a large set of rules that examine the shareholders of these corporations. The *direct and indirect stock exchange* test is a qualification test that requires that the parent company is quoted on a recognised stock exchange in the Netherlands or in the United States and that its shares are regularly traded on this stock exchange. A holding requirement must also be fulfilled if the corporation is to be considered as a ‘qualified person’. If a resident of a contracting state cannot meet these conditions and consequently does not characterise as a qualified person, the resident may still receive benefits according to the other tests found in the LoB clause.¹³⁷

The DTC is applicable if qualified persons own at least fifty per cent of the beneficial interest of a company in a contracting state, the so-called *resident ownership* test. Moreover, the persons have to meet a *base reduction* test, which means that these corporations are not allowed to pay fifty per cent or more of its gross income as deductible expenses to non-residents. This test can be seen as a direct discrimination on the basis of nationality.¹³⁸ The Netherlands-United States DTC is in this context less problematic as

¹³² van Weeghel and van den Berg, *European Taxation* 2004 p.386.

¹³³ Article 26.8.d.

¹³⁴ Article 26.3. The former *derivative benefits* test was found in Article 26.4 of the old DTC, but is now included in Article XXIV of the new Memorandum of Understanding.

¹³⁵ Rienks, *Intertax* 2004/11 p.567, Teunissen and others, *Journal of International Taxation* 2005/3 p.8.

¹³⁶ The *headquarters* test, Article 26.5 and the *shipping and air* test, Article 26.6, are the only qualification tests that will be left aside.

¹³⁷ Article 26.2.c. van Weeghel and van den Berg, *European Taxation* 2004 p.391.

¹³⁸ Article 26.2.f.i (ownership test) and Article 26.2.f.ii (base reduction test). Kofler, *Tax Notes International* 2004 pp.50f, Rienks, *Intertax* 2004/11 p.572.

compared to some other DTCs concluded between the United States and several Member States of the EU. This is the case due to the fact that the Netherlands-United States DTC considers shareholders resident in Member States, with which both contracting states have concluded a DTC, as residents in the Netherlands.¹³⁹ This *equivalent beneficiaries/derivative benefits* test is based on comparable benefits in the treaty with the shareholder's home state. In other words, an unqualified resident company can claim derivative benefits if the EU shareholders could claim equivalent benefits directly from their home state.¹⁴⁰ At least ninety-five per cent of the parent company's shares must be held, directly or indirectly, by seven or fewer persons who are equivalent beneficiaries and have to meet the *base reduction* test. Equivalent beneficiaries are residents of Member States of the EU, EEA or the NAFTA. Foreign residents that meet these criteria can help satisfy the *resident ownership* and *base reduction* tests.¹⁴¹ Saskia Rienks concludes that the test is not taking account to Community law and the conditions for EU shareholders are more demanding as compared to the requirements on Dutch shareholders.¹⁴²

The *active trade or business* test has a purpose of restricting the application of the DTC only to situations where companies have active functions. The potential of abuse is higher if the company has no or a minimal function other than tax saving. This test can only be met if these active functions are carried out in the Netherlands or the United States and consequently it seems to be an indirect discrimination by applying such a provision.¹⁴³

The LoB clauses occasionally contain elements of a subjective nature. The aim with such provisions is to allow the benefits of the DTC to companies that do not fulfil the objective tests. According to these more flexible rules it is up to the competent authority of the contracting state where the income arises to determine whether the company is granted the benefits or not.¹⁴⁴ This *competent authority relief* contains an EU factor, which means that the competent authority shall take into account Community law obligations, according to the Memorandum of Understanding accompanying the tax treaty. Furthermore, the competent authority of the source state will consult with the other contracting state's competent authority before denying the benefits under the subjective clause.¹⁴⁵

¹³⁹ Terra and Wattel (2001) pp.113f.

¹⁴⁰ Article 26.3. Kofler, Tax Notes International 2004 p.68, Panayi, British Tax Review 2003 p.198.

¹⁴¹ Kofler, Tax Notes International 2004 p.49, Rienks, Intertax 2004/11 p.573, van Weeghel and van den Berg, European Taxation 2004 p.392.

¹⁴² Rienks, Intertax 2004/11 p.573.

¹⁴³ Article 26.4. Pistone (2002) p.91, Rienks, Intertax 2004/11 p.573.

¹⁴⁴ Article 26.7. Kofler, Tax Notes International 2004 pp.72f, Martín-Jiménez, EC Tax Review 1995/2 pp.78f.

¹⁴⁵ The 2004 Memorandum of Understanding shows the party's common understanding and is intended to give guidance both to the taxpayer and the tax authorities in interpreting the provisions. It supersedes the old Memorandum of Understanding that accompanied the 1992 DTC and the 1993 Protocol. The EU factor is found in Article XXVIII section c. The Article states that 'in applying paragraph 7 of Article 26 (Limitation on Benefits), the legal requirements for the facilitation of the free flow of capital and persons within the European

The previous version of the Netherlands-United States DTC contained an *EU shareholders* test, but is now replaced by the *equivalent beneficiaries* test. The *EU shareholders* test required that more than seventy per cent of the corporation's shares had to be owned by EU shareholders and thirty per cent must be owned by qualified persons resident in the Netherlands. Even if this test of EU shareholders is replaced, the competent authority in the source state shall grant the available benefits if the requirements are fulfilled according to this test and the *base reduction* test. This is settled in the new Memorandum of Understanding. Of course the *equivalent beneficiaries* test shall be applied initially. Only if the requirements according to that test are not met, the competent authority will grant access to the treaty benefits in line with the *EU shareholders* test.¹⁴⁶

The *substantial presence* requirement is a new test in the LoB article. It is inspired by the United States' willingness to cease inversion transactions into the Netherlands. However, its scope is wider than the described. The company has no substantial presence in a contracting state if certain stock trading conditions are not met.¹⁴⁷ It has been mentioned by Stef van Weeghel and Jean-Paul van den Berg that this qualification test is a well-targeted anti-abuse measure, but that it also can be seen as a 'demonstration of protectionism'. 'An anti-abuse provision that does not define the abuse it intends to counteract is bound to contain overkill'.¹⁴⁸

5.1 Compatibility with EC Law

There are many anti-abuse clauses in international agreements today. Interpretation difficulties are the result of the complexity of these rules. The various interpretations lead to uncertainties for enterprises when determining their available treaty benefits.¹⁴⁹ The attempt of drafting subjective clauses with EC aspects does not counteract this development. Although some scholars believe that these clauses will stand the test against the fundamental freedoms, the uncertainty of applicability leads to discriminatory effects. This will be further developed below.

The Commission decided in 2003 that the LoB clauses in the treaties between the Member States and third countries should be paid particular attention to. Already in 2001 the Commission explained its intention to

Communities, together with the differing internal income tax systems, tax incentive regimes, and existing tax treaty policies among member states of the European Communities, will be considered'.

¹⁴⁶ The *EU shareholders* test was included in the former *derivative benefits* test, Article 26.4 of the old DTC. Is now considered through Article 26.7 of the new DTC and Article XXIV of the Memorandum of Understanding. Rienks, Intertax 2004/11 pp.573f.

¹⁴⁷ Article 26.8.d. Van Weeghel and van den Berg, European Taxation 2004 pp.391f.

¹⁴⁸ Idem p.392.

¹⁴⁹ De Ceulaer, Bulletin 2003 p.498.

examine the LoB provisions in the several international DTCs concluded between Member States and the United States.¹⁵⁰

As the ECJ decided in the *Open Skies* cases, the contracting third state is not obliged to adjust its action to be compatible with the fundamental freedoms, due to the fact that EC law does not bind third countries. The contracting Member State is therefore the only party that can be held responsible for the restricting treaty provisions.¹⁵¹ Consequently, the Member States are not only prevented to conclude new treaties with restricting effects, but also prevented to maintain such existing agreements as the ECJ decided in these judgements.

Discrimination caused by the LoB provisions may still be allowed on pressing reasons of public interest, due to the fact that the Member States see it as a measure to counteract tax treaty abuse. Treaty shopping at the Community level could be seen as a side effect of the not fully integrated internal market. Even if this is true, the increase in investments does normally not outweigh the revenue loss according to the Member States. The states still believe that it is important to counteract such behaviour. However, the ECJ is not specially concerned by forum shopping within the Union and has considered tax jurisdiction shopping a legitimate activity in an internal market.¹⁵² The LoB clauses nevertheless have to be a proportionate means to this objective, even if the prevention of treaty shopping could be seen as a legitimate aim.¹⁵³ In most cases the LoB clauses lead to a disproportionate anti-abuse measure, due to the fact that they go beyond what is necessary to achieve the objectives of the rule.¹⁵⁴

5.1.1 The Objective Clauses

Some 'safe harbours' of the LoB clauses, especially the resident ownership test, might collide with the fundamental freedoms enshrined in the EC Treaty.¹⁵⁵ These 'safe harbours' merely state, by giving a simplified picture of the various clauses, that residents of a contracting state are not entitled to treaty benefits if non-resident companies or individuals control them. The resident ownership percentage test is only a numerical test and consequently not a flexible means of assessing possible abuse. The clause is either fulfilled according to the percentage or not. There is no room for evaluation of the circumstances in the specific case. The simple fact that a corporation has foreign shareholders does not *per se* entail any underlying causes of treaty shopping.¹⁵⁶ The prevention of tax evasion or avoidance may however objectively constitute overriding requirements of general interest, which,

¹⁵⁰ COM (2001) 582 final p.362 and COM (2003) 726 final p.11.

¹⁵¹ Rienks, *Intertax* 2004/11 p.571, Vanistendael, *EC Tax Review* 1999/3 p.164.

¹⁵² The *Centros* case, C-212/97 para.27.

¹⁵³ Panayi, *British Tax Review* 2003 pp.196f.

¹⁵⁴ Pistone (2002) p.91.

¹⁵⁵ Kemmeren, *EC Tax Review* 1997/3 p.151, Kofler, *Tax Notes International* 2004 p.68, Martín-Jiménez, *EC Tax Review* 1995/2 pp.80ff, Panayi, *British Tax Review* 2003 p.195.

¹⁵⁶ Panayi, *British Tax Review* 2003 pp.197f.

according to the rule of reason doctrine, could justify a violation of the fundamental freedoms. Nonetheless, this justification ground has not to this day been found acceptable by the ECJ.¹⁵⁷

The active trade or business test and the other qualification provisions contribute to eliminate some of the discriminatory effects that the resident ownership test is leading to. However, a few discriminatory aspects still remain that may constitute a breach of Community law.¹⁵⁸ The tests are not taking into account the subjective elements of the intention behind the way of organising a group of companies. They are not examining a possible intent of tax evasion or tax avoidance and must therefore be regarded as being too general. The tests are not allowing the taxpayer to provide evidence that demonstrate the legitimacy behind the set-up. The LoB clause with all its various tests does not meet the proportionality criterion and will consequently not be justified under the rule of reason doctrine. The aim with the article could be achieved in a less far-reaching manner.¹⁵⁹

The derivative treaty benefits tests may contribute to solve some of the incompatibilities with EC law. Nevertheless, the provisions do not eliminate all of the infringements.¹⁶⁰ If a shareholder resides in a country with a less advantageous tax treaty than the Netherlands-United States DTC on the particular class of income in question, there would be a violation of EC law.

Dirk van Unnik and Maarten Boudesteijn do not believe that the LoB provision in the 1992 Netherlands-United States DTC infringes the EC treaty. This LoB clause does not allow the United States to do something it could not do entirely on its own through domestic legislation. The Dutch consent is therefore not relevant according to them.¹⁶¹ The author wants to emphasise the reasoning of the ECJ in the *Open Skies* cases. The Court expressly said that the mere existence of a discriminatory nationality clause in a bilateral treaty is contrary to Community law. The possible behaviour of the United States is not relevant in this respect. This reasoning regarding air-traffic rights might be applicable to tax treaties as well.¹⁶² The conclusion made by van Unnik and Boudesteijn was made 1993 before the ECJ had rendered the *Open Skies* cases. Nevertheless, already at that time their conclusion was criticised. Adolfo J. Martín-Jiménez responded in 1995 that the two scholars did not consider the fact that by concluding the treaty with the United States, the Netherlands actually received a more favourable treatment for the resident taxpayers within its territory. Consequently, the

¹⁵⁷ For instance the *Lankhorst-Hohorst* case, C-324/00 para.37, Kofler, Tax Notes International 2004 p.76.

¹⁵⁸ Martín-Jiménez, EC Tax Review 1995/2 pp.83, 86, Panayi, British Tax Review 2003 p.198.

¹⁵⁹ Kofler, Tax Notes International 2004 p.77, Rienks, Intertax 2004/11 p.576.

¹⁶⁰ Kofler, Tax Notes International 2004 p.71, Martín-Jiménez, EC Tax Review 1995/2 p.86.

¹⁶¹ van Unnik and Boudesteijn, EC Tax Review 1993/2 p.115.

¹⁶² See chapter 6.1 and Kofler, Tax Notes International 2004 p.63.

Netherlands divides the internal market if these benefits only are granted to 'qualified' residents.¹⁶³

John F. Avery Jones is not of the opinion that the LoB clauses violate Community law in its present state of harmonisation, not even the most extreme forms of the provisions. His arguments are in short based on the true nature of a tax treaty and reciprocity aspects. The treaty is only a part of the whole picture and no state intends to make a treaty with the entire world when concluding an agreement with one state.¹⁶⁴

The majority of the academics are of the opinion that the objective LoB clauses violate the fundamental freedoms in the EC Treaty. Though, if this is true can the subjective clause neutralise the infringements?

5.1.2 The Subjective Clauses

Some scholars find a solution to the discriminatory effects of the LoB provisions in the subjective clauses. If a company does not qualify for treaty benefits under the various objective tests, the subjective clause can bring a solution. The evaluation by the competent authority of the taxpayer's relevant circumstances can compensate a possible breach of EC law. The Memorandum of Understanding accompanying the Netherlands-United States DTC announces that such relevant circumstances are legal requirements for the compliance with Community law. Adolfo Martín-Jiménez believes that, theoretically, it is possible to conclude that tax treaties containing such a subjective clause are compatible with Community law.¹⁶⁵

Critical remarks against this type of provision have been put forward. Some arguments are that the provision lacks certainty and predictability to the taxpayers. It does not give the internationally owned companies a clear legal position from the beginning, allowing them to claim the treaty benefits.¹⁶⁶ The companies will most likely find the procedure as long and complicated. The considerable administrative burden is a competitive disadvantage in comparison to wholly domestically owned companies.¹⁶⁷ Another fact, which shows that Community law is not completely ensured, is that the Netherlands cannot demand the United States to apply the tax treaty in an EU context, even if the Memorandum of Understanding recognises an EU factor. The ECJ has not regarded this type of recognition to be sufficient. The fundamental freedoms cannot depend on the positive decision of an official.¹⁶⁸ Christiana Panayi declares that 'there is something inherently

¹⁶³ Martín-Jiménez, EC Tax Review 1995/2 p.81.

¹⁶⁴ Avery Jones, EC Tax Review 1998/2 pp.130f.

¹⁶⁵ Martín-Jiménez, EC Tax Review 1995/2 pp.83f, 86.

¹⁶⁶ Kemmeren, EC Tax Review 1997/3 p.151, Kofler, Tax Notes International 2004 p.75.

¹⁶⁷ van Weeghel and van den Berg, European Taxation 2004 p.392.

¹⁶⁸ For instance the *Biehl* case, C-175/88 para.18 where the Court states that 'the Luxembourg Government has not cited any provision imposing *an obligation* [emphasis added] on the administration des contributions to remedy *in every case* [emphasis added]

wrong with fundamental freedoms – which are themselves directly applicable – being subject to the discretion of fiscal authorities’. She is also of the opinion that the existence of even one discriminatory test would render the whole LoB clause discriminatory, due to the fact that it restricts the corporation’s options of available tests. These discriminatory tests are making the exercise of the fundamental freedoms less attractive.¹⁶⁹

the discriminatory consequences arising from the application of the national provision at issue’. Kofler, *Tax Notes International* 2004 pp.74f, Rienks, *Intertax* 2004/11 p.574.

¹⁶⁹ This latter reasoning is moreover supported by Georg W. Kofler in *Tax Notes International* 2004 p.63. Panayi, *British Tax Review* 2003 p.198.

6 The Future Existence of Limitation on Benefits Clauses after the Open Skies Decisions

6.1 Parallels with the Open Skies Agreements and their Nationality Clauses

In the end of 2002 the ECJ gave its judgements in the *Open Skies* cases, which were eight decisions dealing with the legality of bilateral air service agreements. The eight Member States had concluded these treaties with the United States in the area of air transport. The Commission brought action against these Member States and the dispute concerned external competence and discrimination aspects.¹⁷⁰ The ECJ held, *inter alia*, that the ‘nationality clauses’ included in the bilateral air-traffic agreements were discriminatory according to the principle of freedom of establishment. These nationality clauses limited the applicability of the ‘open skies’ agreements to airlines owned by nationals of the contracting states. Consequently, nationals of other Member States did not automatically benefit from the treaty and were discriminated. The discrimination arose solely from the nationality clause in the bilateral treaty and not from any action of the United States. This means that the exclusion of treaty benefits was not a matter that originated from the conduct of the third country, but a result of the treaty itself. In fact the conduct of the United States was irrelevant. The Member States had violated Community law by the mere conclusion and application of the treaties. The public policy argument was rejected as a legitimate justification ground by the Court. The Member States had failed to show a direct link between the threat to public policy and the restriction of air-traffic rights.¹⁷¹

The practical effects of the rulings have not yet been revealed. However, the Commission has requested the Member States, which have concluded ‘open skies’ agreements with the United States, to withdraw the treaties. The Commission has also received a mandate to negotiate a common aviation

¹⁷⁰ The Court’s decision regarding the competence issue has already been mentioned above in chapter 2.3 and will now be left aside.

¹⁷¹ See *supra* note 53 and De Ceulaer, Bulletin 2003 pp.493ff, Kofler, Tax Notes International 2004 pp.52ff, Panayi, British Tax Review 2003 pp.191f, Pistone, EC Tax Review 2005/1 p.6, Rienks, Intertax 2004/11 pp.570f, van den Hurk, EC Tax Review 2004/1 pp.18ff.

agreement with the United States.¹⁷² Furthermore, the Commission brought on 23 December 2004 action against the Netherlands in a new ‘Open Skies’ case¹⁷³. The Commission is of the opinion that the Member State has failed to fulfil its obligation under Articles 5 and 52 EEC (now Articles 10 and 43 EC).¹⁷⁴

Some academics suggest that these cases in the air transport field will have an impact on other areas of Community law, which also includes direct EC tax law. The reason behind this far-reaching conclusion lies in the similarity between the nationality and LoB clauses. The latter is a common feature in tax treaties between Member States and third countries. Both rules restrict the benefits of the treaty they are included in to residents of the contracting states with the goal of preventing loss of revenue through treaty shopping. The resemblance indicates that a similar reasoning could be applied by the ECJ regarding discriminatory LoB clauses in treaties with third countries.¹⁷⁵

6.2 Practical Implications of Recent Case Law of the ECJ

The *Open Skies* decisions did not address the issues of remedies or reparation that follow close behind the declaration of the nationality clauses as incompatible. Therefore, the judgements were of no assistance when assessing possible methods of solving the infringements.¹⁷⁶ Consequently, the Court did not solve the problem of annulment. Will the whole treaty be null and void or only the LoB clause? Another question is if renegotiations and changes in the DTC will be a sufficient remedy or if the Member States are liable for damages according to the principle of state liability.¹⁷⁷ The future case law of the Court will most likely elucidate these uncertainties, but for the time being we must leave it at that.

Frans Vanistendael believes that the LoB provisions are a powerful mechanism to harmonise the Member States’ treaty conditions with the same third country. If there are no discrepancies between the provisions in the Member States’ bilateral treaties with that third country, the identical conditions will ultimately lead to the omission of LoB clauses in relation to that third state. The Member States are in other words acting as one single state in relation to each individual third state in their tax treaty network.¹⁷⁸

¹⁷² Press release of the Commission, reference IP/04/967 and IP/04/1478, Rienks, *Intertax* 2004/11 p.571.

¹⁷³ Pending Case C-523/04.

¹⁷⁴ O.J. on 5 March 2005, C57 pp.19f.

¹⁷⁵ De Ceulaer, *Bulletin* 2003 pp.494, 498f, Pistone, *EC Tax Review* 2005/1 p.6, Rienks, *Intertax* 2004/11 p.570, van den Hurk, *EC Tax Review* 2004/1 pp.25f.

¹⁷⁶ Kofler, *Tax Notes International* 2004 pp.55f.

¹⁷⁷ Panayi, *British Tax Review* 2003 p.201.

¹⁷⁸ Vanistendael, *EC Tax Review* 1999/3 p.166.

6.3 Possible Consequences of the Member States' Omission to Change their Tax Treaties

The Commission could ultimately take action against the reluctance of the Member States to change their discriminatory LoB clauses. The Commission has a possibility to bring the matter before the ECJ, Article 226 EC. Then it is up to the Court to decide the future existence of such clauses. If the ECJ finds the LoB provisions in conflict with Community law, the next step could be a claim on the basis of state liability. However, this is not the only outcome if a LoB clause infringes Community law.

The tax allowance conferred by the Netherlands-United States DTC, which is limited by the LoB clause to residents of those countries, could be regarded as state aid. If the receiver of the benefit is effectively placed in a more favourable economic position than other challenging persons of the Community, the rules could be applicable. Article 87.1 EC states that 'any aid granted by a Member State ... which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market'. Repayment of the aid by the corporations could be the result of finding the effects of the LoB clauses as state aid.¹⁷⁹

6.3.1 State Liability for Damages

The principle of Community loyalty, enshrined in Article 10 EC, is one of the fundamental provisions on which the ECJ relies on when it has to fill various gaps of EC law. The Article has supported the case law holding single Member States liable for damages as a result of the non-implementation or incorrect implementation of EC directives. The joined cases *Francovich and Bonifaci*¹⁸⁰ concerned Italy's failure to implement a Directive, which conferred rights on individuals. This Directive had no direct effect due to insufficient precision. The Court formulated three conditions that need to be fulfilled in order to hold the Member State liable for damages. The Directive must confer rights to individuals and the breach has to be sufficiently serious.¹⁸¹ The last criterion is that there must be a direct causal link between the breach and the harm suffered by the individual. Moreover, there has to be a violation of Community law and in this case the Court had already concluded such infringement in an earlier

¹⁷⁹ Panayi, *British Tax Review* 2003 pp.201f.

¹⁸⁰ Judgement of the Court on 19 November 1991, Joined cases C-6/90 and C-9/90.

¹⁸¹ The latter condition has been elucidated in later judgements.

judgement. In later decisions¹⁸² the ECJ has concluded that it is not relevant if the violation concerned directly applicable Community provisions.¹⁸³

Considering this case law, the Member States may be liable for damages if the breach, which the discriminatory LoB article causes, is regarded as sufficiently serious by the ECJ. Probably a judgement of the Court concluding that the LoB clause is contrary to one of the fundamental freedoms would be considered as a sufficiently serious violation. Moreover, the other two criteria seem to be met in this case. Both natural and legal persons can hold Member States liable for compensation for losses they have suffered.¹⁸⁴

The ECJ can give some guidance to the principle of state liability for damages in the *ACT Test Claimants* decision.¹⁸⁵ This case actually deals with the MFN principle and not LoB provisions. However, if the Court would render the Member State liable for damages due to the discriminatory tax treaty, the ruling could have implications on other discriminatory features of tax treaties. If the LoB articles are found contrary to EC law, this case law can be relevant. It is on the other hand not certain if the Court will answer the questions of potential remedies. The topic is only examined if the first preliminary question is answered in the affirmative. This question addresses the issue of the MFN doctrine and its support in Community law. It is the second preliminary question that relates to available Community rights and remedies.¹⁸⁶

¹⁸² The *Brasserie du Pêcheur II* and *Factortame III* cases, joined cases C-46/93 and C-48/93, dealt with primary Community law.

¹⁸³ Terra and Kajus (2004) pp.28, 147ff, Terra and Wattel (2001) p.114, van den Hurk, EC Tax Review 2004/1 pp.28f.

¹⁸⁴ Kemmeren, EC Tax Review 1997/3 p.151, Rienks, Intertax 2004/11 p.576, Terra and Wattel (2001) p.114, van den Hurk, EC Tax Review 2004/1 pp.29f.

¹⁸⁵ Pending case C-374/04.

¹⁸⁶ Reference for a preliminary ruling in case C-374/04, O.J. 6.11.2004 C273 pp.17f.

7 Analysis and Conclusions

7.1 Most-Favoured-Nation Principle

Eric Kemmeren is of the opinion that the ECJ already has turned down the MFN treatment in direct tax law by its judgement in the *Bachmann* case. The author would like to emphasise that if this is the correct analysis the Court will most likely announce this in the '*D*', *Bujura* or in the *ACT Test Claimants* case. Nonetheless, the author believes that the Court will find that the non-discrimination principle in Article 12 EC contains a 'limited' MFN standard. The arguments put forward by the 'believers', regarding the irrationality of not requiring a horizontal non-discrimination within the Community, are convincing.

7.2 Limitation on Benefits Provisions

When turning to the other issue of this thesis, the compatibility of LoB clauses with EC law, the author assumes that the ECJ will find these rules incompatible with Community law. Even if this assumption is represented by the majority of writers in the tax field some other issues, which might follow close behind such a ruling, is still unresolved. Will the whole bilateral tax agreement be invalidated or only the LoB clause? The Court has not, as stated above, given an answer to this question. Nevertheless, some thoughts regarding this issue will be presented. If the Court finds the LoB provision null and void, this could mean that the fundamental conditions of the tax treaty are thrown over. The better solution may be to annul the whole treaty, which results in a possibility to re-negotiate the treaty conditions. The effect of only invalidating the LoB clause could result in a situation where treaty benefits are available to numerous of companies, not only corporations residing in Member States. By rendering the whole treaty as invalid the States are given a second chance to address the Community law issues without far-reaching effects. However, if the Court does not find the LoB clause as a fundamental condition of the agreement, the annulment of the single clause might do. It all comes down to this. The whole treaty with all its provision and how they are interacting must be regarded in such a decision.

There can emerge some hierarchy dilemmas between overlapping provisions in a DTC when applying the agreement. For instance, how does a general non-discrimination principle in a bilateral tax treaty correspond to a discriminatory LoB clause?¹⁸⁷ Does such a wide provision with the intent of non-discrimination prevail and render the LoB clause inapplicable? The purpose of the parties must to a certain extent be to treat each other's

¹⁸⁷ For example the 1992 Netherlands-United States income tax treaty has a non-discrimination clause, Article 28, as well as a LoB clause, Article 26.

residents, which are in similar situations, likewise. Nonetheless, exceptions are made when the states fight tax treaty abuse, something that the LoB clauses are counteracting. Even if the contracting parties have the intention not to discriminate domestic corporations with foreign shareholders, the effect of applying a LoB provision gives rise to such an outcome. The LoB clauses actually allow discrimination against Union citizens. These provisions are more specific rules than the general non-discrimination provisions. According to interpretation rules this *lex specialis* clause must supersede the more extensive one. This is the likely conclusion when merely applying international law. However, as mentioned above the conclusions would not be the same according to Community law. If this source of law is more advantageous to the Union citizen it must prevail and in this case it certainly does.

7.3 Can the Most-Favoured-Nation Principle Influence the Future Use of Limitation on Benefits Clauses?

The most interesting task of this thesis, according to the author's own opinion, is to analyse how the two features, the MFN doctrine and the LoB clauses, can be brought together or if this is possible at all. The lack of such a discussion in tax literature is remarkable. Scholars mention the two characteristics in the same articles, but they do not express any theories of their plausible interaction. Luc Hinnekens is an exception. Even if he only gives a short statement regarding this issue, is he one of few that actually has a comment. Hinnekens is against an application of the MFN principle to the LoB clauses. 'The specific application of MFN to LOB could have the effect of defeating the rationale of LOB and jeopardize the entire Article. The most attractive and shoppable treaties of Member States are those without any limitation of benefits article. Should, in the name of the internal market and of non-discrimination, EC tax treaties be downgraded to a no-LOB standard, thereby achieving the lowest level of functional integrity of tax treaty law?'¹⁸⁸

The author does not agree with this reasoning. The MFN treatment is not relevant to the isolated LoB clause. A taxpayer does not intend to extend the restrictive LoB provision, which excludes benefits to non-qualified persons. Instead the person requires the extension of a certain treaty benefit. This advantage is found in another article of the income tax treaty. Namely, the MFN principle focuses on the provisions in a DTC that are entitling to benefits not provisions like the LoB clauses, which are limiting the scope of the agreement.

A 'limited' MFN treatment does not lead to a no-LoB standard as Hinnekens believes. When a taxpayer residing in a Member State is in a similar situation as another Union citizen, and if there are no objective

¹⁸⁸ Hinnekens, EC Tax Review 1995/4 p.230.

justification grounds, the purpose of the LoB clause cannot be fulfilled in this specific situation. If it can be shown in a certain case that there are abusive intentions behind the claim of a MFN treatment, the refusal of extending the benefits must be regarded as an objective justification ground and the MFN treatment is not leading to a different result than the LoB clause. When it comes to the compatibility of the LoB clause itself without the involvement of the MFN standard, this examination can most certainly lead to a situation where the LoB provision is precluded within a Community perspective. This could be the case if the *Open Skies* decisions affect the ruling of the ECJ in a similar tax case. However, the application of the MFN principle will hopefully not result in a no-LoB standard, due to the fact that a general and unconditional application of the doctrine is not desirable. The author believes that the LoB rules and MFN treatment are two different features and that if a LoB clause violates the fundamental freedoms the MFN principle is not the right tool to use in preventing such discrimination.

In the beginning of the thesis the author raised three issues that could be of importance in a situation where the two characteristics might interact. Here it is time to answer these questions on the basis of the opinions expressed in the academic debate regarding the two features and the facts revealed in earlier chapters.

- Can the application of the MFN standard and the invalidation of a LoB provision lead to different results?

The author will now illustrate an example where different results are achieved by the annulment of a LoB clause and the application of the MFN principle. Member State A has concluded a DTC with a third country. In the agreement a withholding tax of five per cent is prescribed. Member State B has also concluded a DTC with the same third country. This DTC prescribes the identical withholding tax percentage. Member State C has negotiated a ten per cent withholding tax rate with this third country.

Company A-B residing in Member State A has its parent company in Member State B. According to the derivative benefits test in the DTC between Member State A and the third country, *Company A-B* is entitled to a withholding tax rate of five per cent. This is the case due to the fact that the parent company could receive the same benefit directly from Member State B's DTC. *Company A-C* is a resident of Member State A and its parent company is a resident of Member State C. *Company A-C* is not a qualified person according to the tests in the LoB clause included in the DTC between Member State A and the third country. The withholding tax rate of ten per cent makes it impossible for *Company A-C* to use the derivative benefits test.

Company A-C can now require the five per cent withholding tax rate according to, on the one hand, the MFN principle and on the other, the annulment of the discriminatory LoB provision. If *Company A-C* with its

parent company is in an objectively comparable situation to *Company A-B* and its parent company, the MFN principle is applicable. The principle precludes horizontal discrimination between Community citizens. *Company A-C* is then entitled to the five per cent rate, but not any other benefits of the treaty. If the LoB article is found contrary to EC law it could lead to the situation that every other corporation with a parent company residing in the Union must be granted any benefit in the DTC and not just the favourable five per cent withholding tax rate. The DTC will be totally defenceless.

Two non-resident taxpayers must be in a similar situation if the horizontal non-discrimination MFN principle shall have effect. This could mean that in a case where Member State A only gives certain benefits to third countries and not to any other Member States, the horizontal comparison between non-residents of two Member State are impossible. The MFN treatment cannot be used in these situations. If the LoB clause of the tax treaty concluded between the Member State and the third country is regarded as discriminatory, the residents of the European Union will be able to claim the treaty favours. In other words the two features can lead to different results. The MFN treatment must be considered to be a more limited tool than invalidating the discriminatory LoB clauses, due to the comparative element of the 'limited' MFN principle.

The author would like to summarise the main conclusions. The 'limited' MFN standard extends the applicability of a *specific* benefit in a *specific* case, not *all* treaty benefits in *every* case, unlike the result of a possible annulment of a discriminatory LoB clause.

- Can the Court's judgement of relevant justification grounds in a case where both the MFN treatment and LoB clauses are examined, lead to two different results?

Another aspect that the author is questioning is if the Court will make the same evaluation regarding the justification grounds of, on the one hand, a restricting LoB clause and on the other, a possible rejection of extending a tax treaty benefit to another Member State according to the MFN doctrine. In other words, will the national Governments' arguments relating to LoB provisions and MFN treatment be equally treated?

Even if Community law allows a certain LoB provision, the treaty benefits can nevertheless be extended to other Member States according to the MFN doctrine. By this extension the sole purpose of the LoB provision is ruined. Only towards companies or persons from third states these limitations can be upheld. However, if there are justifiable grounds to discriminate against Community citizens in a certain treaty LoB clause, there will most certainly be legitimate reasons to disregard the MFN treatment. If the ECJ decides in the '*D*', *Bujura* or the *ACT Test Claimants* case that a 'limited' MFN principle has a place in direct EC tax law, the ordinary justification rules will apply in these situations. This cannot be said if the Court welcomes a general MFN principle. If the author has understood the general MFN

application correctly, this means that no grounds of justification are available in such cases. The MFN treatment would be obtainable without any exceptions. The reluctance of the ECJ to decide upon new controversial and far-reaching principles will definitely prevent the general MFN standard from emerging in direct EC tax law. Because of that reason and the arguments put forward by the 'believers', the author has faith in the existence of a 'limited' MFN doctrine in direct Community tax law.

As explained in the beginning of the thesis, the inherent purposes of the two features are totally different. The MFN standard is a positive tax measure and the LoB is trying to prevent that parties without a strong nexus to the contracting state receive the benefits in a bilateral treaty. The two features are found in different articles. If these articles are looked at isolated and not in the light of the whole treaty, the conclusion will most likely be that they have diverse purposes. The LoB clauses are restrictive ones with, as the states express by themselves, purposes of preventing tax treaty shopping. The application of the MFN treatment is not intended to extend this restrictive article. The benefits, which the taxpayer wants to receive, are put down in other articles. The aim of the taxpayer is rather to extend another provision in the same tax treaty, which acknowledges benefits to the residents of the contracting States, but not to residents of the taxpayer's Member State. Even if the objectives behind the articles are different, the effect of not allowing the LoB provision or applying the MFN standard is however the same. The comparable effects are that persons initially not entitled to treaty benefits, are granted these benefits through Community law according to non-discrimination principles. The Member States will consequently put forward the same arguments when trying to justify their measures. If the ECJ renders the Member States' effort to counteract tax evasion or tax avoidance through the LoB clauses as an acceptable justification ground, the same argument would probably stand the test concerning the MFN doctrine. The Member States would address a case of a possible MFN treatment with the same arguments as the ones that they are using when defending their LoB articles, namely, arguments relating to anti-treaty shopping aspects. It is a condition that the ECJ already has accepted the MFN standard in direct Community tax law. If this is not the case, arguments concerning the specific principle and its position in EC law will of course dominate the reasoning. The Court must make the same evaluation and conclusions if the effects of disregarding the Member State's justification grounds of the two features are exactly the same. If different outcomes will be the result of the Court's examination, then we are back to the hierarchy problem.

- If a taxpayer claims entitlement to a treaty benefit, both according to the MFN principle and by annulment of a LoB provision, which one will prevail?

If the LoB article restricts the applicability of the treaty and the MFN principle demands extension of the benefits, which one will prevail? Is the decision of not allowing the nationality clauses in the *Open Skies*

judgements the same as giving the non-discrimination principle supremacy? This could be the case if the MFN principle is considered as just another side of the non-discrimination principle and such an argument could lead to the conclusion that the MFN treatment must prevail.

The MFN treatment will not lead to a general extension of the treaty benefits. In a certain case, according to the specific circumstances, the favour will be given to a taxpayer initially not granted the benefit. The person is then entitled to a specific treaty benefit and not entitled to all of the favours included in the treaty. The MFN doctrine does not have the effect of invalidating the discriminatory LoB clause. The principle only renders the LoB clause not applicable in the specific case according to the MFN principle's supremacy. The judgement of allowing or precluding the LoB clause in a tax treaty is of a more general character. One case demanding MFN treatment will not automatically lead to termination of the LoB clause. The provision still functions against taxpayers without a strong nexus to one of the contracting states. If the MFN doctrine is brought up again relating to the same treaty benefit, it will be a separate and new evaluation. The MFN treatment is to be applied on a case-by-case basis. The unintended effects will consequently be counteracted. The practical effects of applying the MFN treatment will of course oblige the Member States to change their approach regarding the LoB issue, but only towards nationals of other Member States.

If a discriminatory LoB article is found justified by Community law, but the MFN treatment extends a certain tax treaty benefit in the same agreement, the latter more specific non-discrimination principle must prevail in the author's opinion.

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