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Does the LOB clause in BEPS Action 6 violate the principle of MFN treatment in EU law?

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Summary

OECD delivered on October 5th 2015 the BEPS final package consisting of 15 actions intending to address the issues of base erosion and profit shifting. The aim of Action 6 is to prevent treaty abuse, in particular treaty shopping. To achieve this goal, a specific anti- abuse rule, a Limitation- on- Benefit (LOB) rule, will be included in the OECD Model. The LOB rule contains objective tests that the taxpayer in question must satisfy in order to be granted benefits under a tax treaty. Hence, it does not, in general, refer to the intention of the taxpayer. The granting of such benefits has been based on residency of the party claiming the benefits, which, as a consequence, has created opportunities for tax treaty abuse. Hence, the LOB rule limits the application of Article 1 of the OECD Model Convention, according to which the Convention applies to a person resident of a contracting state.

The BEPS project will be implemented in the tax treaties concluded between different states. However, as it constitutes soft law, EU law still prevails. Consequently, issues may arise as EU law and the BEPS proposal constitute different sources of law and may not always be compatible as they serve somewhat different purposes. As BEPS may have restrictive effects on the freedom to move in order to prevent treaty abuse, the EU aims at ensuring an internal market with free movement.

The Most- Favoured- Nation (MFN) treatment constitutes a cornerstone in the WTO law, which aims to provide undistorted import and export between different markets. It has for a long time been disputed whether EU law also contains a principle of MFN treatment through the application of Article 18 of the TFEU in combination with the fundamental freedoms. The MFN treatment derives from the concept of horizontal discrimination, which refers to the situation in which two non resident taxpayers, resident in different Member States, are objectively comparable and subject to unequal treatment. This question has been disputable since in particular vertical discrimination has been prohibited under Article 18 of the TFEU. The issue whether horizontal discrimination should be prohibited within the EU has been dealt with by the case law of the CJEU. The core question has been whether two non- residents are in an objectively comparable situation.

Hence, in this thesis, case law of the CJEU dealing with the existence of an MFN treatment within the EU is being analysed. The conclusion is that a prohibition against horizontal discrimination within the EU does exist. The following question to be dealt with concerns the correlation between the MFN treatment and the LOB rule proposed in the Action 6. To this end, the MFN treatment should not be applied as a remedy of an LOB rule that creates discriminatory effects, although acceptance of the MFN treatment and the refusal of the LOB clause in a specific situation lead to the same result.

Sammanfattning

Den 5 oktober 2015 levererade OECD en Action Plan (BEPS) som består av 15 åtgärdsplaner (actions) i syfte att bekämpa problematiken avseende skatteerodering och vinstförflyttning. Action 6 syftar till att bekämpa missbruk av skatteavtal, i synnerhet treaty shopping. För att uppnå målsättningen föreslås att en Limitation- on- Benefit (LOB) regel, som utgör en specifik skatteflyktsregel, ska införas i OECD' s modellavtal. LOB regeln består av objektiva test som ska uppfyllas för att den skatteskyldige ska omfattas av de skatteförmåner som skatteavtalet i fråga medger. Således hänför sig testen inte till skattebetalarens syfte avseende en etablering i den kontrakterande staten som omfattas av skatteavtalet. Medgivande av skatteförmåner har baserat sig på ett hemvistkriterium vilket har möjliggjort för missbruk av skatteavtal. Följaktligen begränsar LOB regeln tillämpningen av Artikel 1 i OECD' s modellavtal som stadgar att modellavtalet tillämpas på personer med hemvist i en av de avtalslutande staterna.

Den Action Plan som föreslås implementeras i medlemsstaternas skatteavtal utgör ”soft law”, vilket innebär att EU rätten har företräde. EU- rätten och OECD' s förslag är inte alltid förenliga, vilket innebär att problem kan uppstå då de tjänar delvis olika ändamål. BEPS avser att motverka skattemissbruk och riskerar därmed att utgöra inskränkningar avseende rätten till fri rörlighet och förbudet mot diskriminering inom EU. EU- rätten, å andra sidan, syftar till att bidra till en inre marknad inom EU med fri rörlighet.

Most- Favoured- Nation (MFN) principen utgör en viktig del av WTO rätten, som syftar till att säkerställa en icke snedvriden konkurrens mellan olika marknader. Det har under lång tid varit omtvistat om EU-rätten också inkluderar en MFN princip genom en tillämpning av Artikel 18 i TFEU i kombination med de grundläggande friheterna som råder inom EU. MFN principen härrör från konceptet avseende horisontell diskriminering, som avser en situation där två personer med hemvist i olika stater befinner sig i objektiva jämförbara situationer och föremål för olika behandling. Frågan har varit omdiskuterad då i synnerhet vertikal diskriminering har ansetts omfattas av diskrimineringsförbudet i Artikel 18 i TFEU. Frågan om även horisontell diskriminering omfattas av EU rätten har varit föremål för EU domstolens bedömning. Kärnfrågan har i de flesta fall varit om två personer med hemvist i olika stater befinner sig i objektiva jämförbara situationer.

I denna uppsats analyseras rättsfall där frågan om MFN principens existens i EU rätten behandlas. Slutsatsen är att ett förbud mot horisontell diskriminering inom EU existerar. Följande fråga som behandlas avser förhållandet mellan LOB regeln och MFN principen. Den slutsats som dras är att MFN principen inte bör tillämpas i syfte att komma till rätta med de diskriminerande effekter som LOB regeln kan ge upphov till, trots att en

acceptans av MFN principen och ett avslag av LOB regeln i en specifik situation torde leda till samma resultat.

Preface

I got inspired to write about this topic after having participated at one of the seminars held by Cécile Brokelind at the master's program in European and International Tax Law in Lund. I would like to thank her for a challenging and inspiring year.

I would like to thank my supervisor Christina Moëll for carefully reading this manuscript and for providing me with important and insightful opinions. I would also like to express my gratitude to Alexis and Andrew Rapo for their comments on this project.

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Sascha Åkerman

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Abbreviations

AG	Advocate General
Art.	Article
BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Corporation
EU	European Union
GATT	General Agreement on Tariffs and Trade
LOB	Limitation- on- Benefits
MFN	Most-Favoured- Nation
n.	(Foot)- note
OECD	Organization of Economic Cooperation and Development
OECD Model	Model Tax Convention on Income and on Capital (2014)
Para.	Paragraph
TEU	Treaty of the European Union
TFEU	Treaty of Functioning of the European Union
UNCTAD	United Nations Conference on Trade and Development
Vol.	Volume
WTO	World Trade Organisation

1 Introduction

1.1 Background

In 2013, OECD initiated an Action Plan to address Base Erosion and Profit Shifting (BEPS) issues, in order for profits to be taxed where economic activities take place and where value is created. The opportunities for BEPS have mainly been created as a consequence of the globalisation, which has enabled for multinational enterprises to shift their profits to beneficial tax jurisdictions. One of the most important BEPS concerns is to prevent treaty abuse, in particular treaty shopping. To deal with treaty shopping, Action 6 contains a limitation on benefit (LOB) clause¹, which limits the possibility for entities to obtain treaty benefits. Hence, in order for a resident of a contracting state to obtain benefits under a tax treaty that contains an LOB clause, it must constitute a “qualified person”, which it does if it satisfies one of the objective tests contained in the LOB clause.

Since the BEPS project constitutes soft law and does not override EU law, conflicts may arise between the different sources of law. While the fundamental freedoms² in EU law aims at ensuring the internal market and economic tax neutrality by providing free movement, the BEPS project intends to curtail tax planning structures that apply in cross border situations. Hence, the BEPS project may include restrictive or discriminative measures with regard to cross border activities.

Article 18 of the Treaty on the Functioning of the European Union (TFEU) contains a general prohibition of any discrimination based on nationality within the EU. In particular, Article 18 of the TFEU prohibits vertical discrimination meaning that if a Member State treats a national of another Member State worse than its own nationals, it constitutes prohibited discrimination.³ It has been disputable whether also horizontal discrimination, consisting of discrimination between citizens of different EU Member States, is also covered by the scope of the principle of non-discrimination within the EU.⁴ Horizontal discrimination exists in case two non residents from different Member States are in objectively comparable situations and subject to unequal treatment, why the question of whether two non- residents are in objectively comparable situations is of an important matter for this analysis. Hence, the question is whether EU law contains a legal basis for a most- favoured- nation (MFN) treatment⁵, which

¹ In this thesis, the terms “LOB clause” and “LOB rule” will be used synonymously.

² The terms *fundamental freedoms* and *the freedom to move* refer to the fundamental freedoms within the EU. To revise these freedoms, see chapter 3.

³ C- 1/93 *Halliburton*.

⁴ It should be highlighted that the question of how a citizen will be treated in its own state of residence will lack relevance in order to answer the legal questions of this thesis.

⁵ Please note that the terms *MFN principle* and *MFN treatment* will occur. These terms will have the same meaning in this thesis.

derives from the concept of horizontal discrimination. The issue may arise with regard to tax benefits granted under a tax treaty to a resident of a contracting state, where a resident of a non contracting state requests to be granted the same benefit. The principle of MFN treatment constitutes a “cornerstone” of the General Agreement on Tariffs and Trade (GATT), which is a part of the World Trade Organisation (WTO) and promotes free trade within the EU. However, with regard to the field of direct taxation within the EU, the existence of an MFN treatment is somewhat unclear.

Some authors have argued that the combination of the provisions of the fundamental freedoms and the non-discrimination provision in Article 18 of the TFEU prohibits horizontal discrimination and, consequently, contains a principle of MFN treatment. That would be in line with the aim of the EU to achieve an internal market with free movement. Others argue that an obligation of the Member States to enact an MFN treatment would undermine the balance and reciprocity of tax treaties.

The concept of horizontal discrimination has been under scrutiny in the case law of the Court of Justice of the European Union (CJEU). However, the question remains what impact the principle of MFN treatment may have on the LOB clause since they, as will be further analysed in section 5.1.3, serve different purposes. BEPS, EU law and WTO law constitute three sources of law that will be of importance to provide a clearer answer to the legal issue regarding the interaction of the principle of MFN treatment within the EU and the LOB clause proposed in the BEPS project.

1.2 Purpose

The purpose of this thesis is to answer the following questions:

- Does EU law contain a principle of MFN treatment?
- Can the principle of MFN treatment apply to the LOB clause?

In order to achieve the above-mentioned legal questions, an analysis of the case law dealing with horizontal discrimination will be provided in order to assess whether an obligation of the EU Member States to enact the principle of MFN treatment has been developed. The question is to what extent the principle is covered by the non-discrimination principle in Article 18 of the TFEU in combination with the fundamental freedoms in order to achieve the aim of the EU to create an internal market. As these provisions do not provide an explicit answer, the case law of the CJEU is being analysed to assess whether there are situations when the CJEU has obliged a Member State to extend benefits granted to the resident of the most-favoured-nation to the resident of the third state that is being discriminated. Hence, the method of a teleological method of interpretation of the CJEU is of a significant matter in order to answer the legal question regarding the existence of an MFN principle within the EU. In such case, the question arises whether the principle of MFN treatment may rule out the LOB clause,

which prohibits a person who does not satisfy one of the tests in the LOB clause to be granted the benefit in question. The question is whether the two concepts correlate or not.

1.3 Method and Material

The basic purpose of this thesis is to analyse the potential conflict between two particular sources of law serving somewhat different purposes, namely BEPS and EU law. Therefore, the appropriate method being used in this thesis is a legal dogmatic method. Furthermore, the legal sources are used in accordance with the legal doctrine.⁶ By applying a legal dogmatic method, current sources as they stand today will be described and analysed. The characteristics of the legal dogmatic method concern the research of statutes, principles, case law and literature.⁷

The legal dogmatic method does, in order to answer the legal questions presented with regard to this thesis, not focus on the domestic law of a certain state. However, the relation between BEPS and EU law, and to some extent WTO law, constitute an important part of this thesis. Consequently, the question is whether some elements of comparative method are being used in addition to the dogmatic legal method. It is clear that a comparative method is not being used in an extensive manner. However, it could be argued that a comparative method is being used with regard to BEPS and EU law when comparing the effects of a discriminative LOB clause with the application of an MFN treatment. The two sources of law are not being compared throughout the thesis, since it rather focuses on two different concepts that may correlate to some degree. Hence, the correlation between the two concepts is to some extent being assessed as well as the impact of EU law on BEPS, more particularly, the LOB clause, which may constitute elements of a comparative method. Additionally, the fact that WTO law contains a principle of MFN treatment should be highlighted as it is being mentioned in the thesis. On this matter, it could be argued that a comparative method is being used to a small extent when assessing the principle of MFN treatment in WTO law and in EU law.

The starting point regarding the material being used when applying the legal dogmatic method is the primary sources of law. To this extent, as already mentioned, three sources of law consisting of EU law, WTO law and BEPS are used. The legal sources of EU law, which constitutes an important part of the material being used in order to answer the legal questions presented, comprise of primary law and secondary law. The primary law consists of the EU Treaties (TEU and TFEU), which constitutes legal instruments created by the Member States. To this extent, general principles implemented in the EU primary law are being used. The secondary source of law consists of legal acts, legislated by the institutions of the EU.⁸ Since the CJEU shall

⁶ Sandgren (2009), p.118.

⁷ Vranken (2012), p.43.

⁸ Borchardt (2010), p.80 f.

interpret and apply the EU Treaties according to Article 19.1 of the Treaty of the European Union (TEU), the case law of the CJEU constitute an important source of law and material when using the legal dogmatic method since the EU Treaties do not provide a clear answer. Additionally, literature is being used. It constitutes, *inter alia*, an important source being used to assess the opinions of different authors, since the CJEU does not always provide explicit answers regarding the legal questions of this thesis. To this end, both books and articles are being described and analysed. The BEPS project is also a source being used to a large extent in order to assess the LOB clause. However, as already mentioned, the BEPS constitutes soft law, as the Member States of the EU are not obliged to implement the actions. However, the legal dogmatic method means that the EU law prevails over BEPS. In this thesis, the BEPS project will be described before focusing on EU law. It should be mentioned that this disposition has nothing to do with the order of the legal doctrine.

1.4 Previous Research

Previous research regarding the compatibility of the LOB clause with EU law exists to a large extent. International tax journals address this issue. The issue of horizontal comparability has been scrutinized in several articles. Gerard Meussen has brought up the issue of horizontal discrimination in the light of the *Sopora* case, a case which will be further analysed in this thesis. I.M. de Groot has also dealt with the question of whether the Member States of the EU are obliged to enact an MFN treatment under EU law. The issue of MFN treatment under EU law in this article deals with both unilateral MFN treatment with regard to domestic measures, and whether the MFN treatment applies to tax treaties.

The question that concerns the interaction of the MFN treatment and the LOB clause has not been subject to extensive academic debate. Anitza Zester has written an article published in 2006 regarding this matter. Additionally, the *ACT Group Litigation* case indirectly concerned the interaction of the MFN treatment and the LOB clause, since the LOB clause referred to the reasoning of the CJEU regarding the MFN issue. The case has been used in order to analyse whether the ruling of the CJEU constituted an error when referring to the reasoning of the MFN issue when dealing with the question of whether the LOB clause is compatible with EU law.

1.5 Delimitations

Initially, it should be mentioned that the LOB clause is one of the proposed measures in order to combat treaty abuse. The Principle Purpose Test (PPT) is another measure that could be combined with the LOB clause in order to achieve this purpose. However, the PPT rule will only be shortly mentioned and not subject to any extensive investigation. Further, the part of the LOB clause that is relevant for this topic is the five tests that concern entities. Onwards, the proposed LOB clause in Action 6 contains both a simplified

version and a detailed version. This thesis will only focus on the detailed version.

The potential conflict of the LOB clause with the EU fundamental freedoms has been subject to extensive academic debate, hence an analysis with regard to that field has been left out of this project.⁹ The issue is only shortly being mentioned in Chapter 3. Another EU issue that may arise regarding the LOB clause is the compatibility with Article 107 of the TFEU, dealing with state aid, which has not been scrutinized in this thesis to any extent. In case the LOB clause infringes EU law, the questions regarding state liability and legal consequences arise. Will the whole treaty that contains the LOB clause be invalid, or only the LOB clause? Tax treaties are the result of “give and take” and negotiations between the contracting states¹⁰, why it may be inappropriate to invalidate the isolated provision instead of re-negotiating the entire treaty.¹¹ Another question that may occur regarding LOB clauses is whether such specific anti- abuse provisions are actually necessary in order to establish a minimum level of protection against treaty abuse. These issues will not be further dealt with.

The European Commission has launched a Tax Transparency Package to combat corporate tax avoidance and harmful tax competition, which builds on the OECD Action Plan and will not be subject to an exhaustive investigation.

The focus mainly relates to the MFN treatment within the EU and not beyond the EU. Another question that could be further analysed is whether the principle of MFN treatment obliges the Member States to apply the same standard to nationals of other Member States as it does towards nationals of third countries. However, this issue will not be completely left out as some case law deals with benefits granted to resident of third countries under tax treaties concluded with Member States of the EU.¹²

⁹ For further reading with regard to this topic, see, *inter alia*, Panayi, Bulletin for International Taxation Vol. 70 No 1/2 (2016) & Debelva et. al., EC Tax Review Vol. 24 Issue 3 (2015).

¹⁰ The term *contracting state* refers to a state that has concluded a tax treaty with another state.

¹¹ Zester, Intertax Vol. 34, Issue 3 (2006) p. 147.

¹² See, *inter alia*, C- 55/00, Gottardo & C- 466/98 *Commission v United Kingdom*, which both concern non- tax case law.

1.6 Outline

Subsequent chapter 2 concerns the issue of international tax planning and the BEPS project initiated by OECD and the G20 countries. Five tests included in the LOB clause in order to determine whether a company has a sufficiently strong nexus to a jurisdiction are also described in this chapter in order to contribute with an understanding of how the LOB clause is constructed. This chapter is predominantly descriptive.

Chapter 3 concerns EU law and gives a non exhaustive description on the fundamental freedoms and the steps made by the CJEU in order to address whether a measure is discriminative or restrictive. The chapter contains a section describing the non- discrimination provision that is implemented in Article 18 of the TFEU. The issue of MFN is addressed in order to provide an understanding of how it might be connected to the EU law.

Chapter 4 deals with the question of whether EU law applies on tax treaties. The issue is not a new topic but it is important to provide the reader with an understanding regarding that matter since the issue of horizontal discrimination does, *inter alia*, occur by the application on tax treaties. Would the freedom to conclude contract prevail over EU law, no issue of any discrimination would arise as the result of the application of tax treaties.

Chapter 5 and chapter 6 are more analytical chapters, which deal with the case law of the CJEU concerning the issue of the principle of MFN treatment and the correlation between MFN treatment and the LOB clause.

Finally, chapter 7 contains the final remarks and will provide an analytical answer to the questions asked in chapter 1.2.

2 The issue of international tax planning

2.1 Improper use of tax treaties and treaty shopping

Historically, the main reason for concluding tax treaties have been to avoid double taxation.¹³ International juridical double taxation has occurred when comparable taxes in more than one state have been imposed on the same taxpayer regarding the same subject and for the same periods.¹⁴ Today, 3000 tax treaties are currently in force. Tax treaties allocate the right to tax income to one state or split the right of taxation between the two contracting states. Additional intentions are to prevent tax avoidance, to achieve a fair allocation of taxation powers between the states and to counteract discrimination.¹⁵

According the Commentary to the first draft of the OECD Model, which was developed by the League of Nations, single taxation is a fundamental requirement regarding to the principles of fiscal justice.¹⁶ The aim of combating both double taxation and tax evasion are still the main purposes with tax treaties.¹⁷ However, it is common that double non-taxation is the result of arranged transactions of the taxpayer in situations not in accordance with the intention of the contracting states.¹⁸ Thus, tax treaties may be improperly used in case taxpayers exploit differences between the laws of different states.¹⁹ Such conducts may for instance result in market distortions as a result of differences in competition between businesses, which derive from, *inter alia*, different taxation of similar businesses.²⁰ Aggressive tax planning, which will be described in this section, also harms governments as a cause of less revenue. Additionally, individual taxpayers are harmed since they have to bear a greater share of the burden when other taxpayers reduce their tax burden by shifting their profit away from the jurisdiction where their activities are carried out.²¹

¹³ Hilling (2016) p. 34 f.

¹⁴ OECD, *Model Tax Convention on Income and on Capital*, (OECD Publishing 2015), p. I-1.

¹⁵ Hilling (2016) p. 34 f.

¹⁶ League of Nations, *Report presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, Publications of the League of Nations Publications, C. 216.M. 85. 1927. II., p. 23.; Hilling (2016) p. 40.f.

¹⁷ OECD, *Model Tax Convention on Income and on Capital*, (OECD Publishing 2015), Commentary on Article 1, para 7.

¹⁸ Hilling (2016), p. 40 ff.

¹⁹ OECD, *Model Tax Convention on Income and on Capital*, (OECD Publishing 2015), Commentary on Article 1, para. 7.1.

²⁰ Hilling (2016), p. 42.

²¹ OECD, *Action Plan on Base Erosion and Profit Shifting*, (OECD Publishing 2013), p.8.

A tax treaty should not be used to evade taxes of the contracting states but be applied correctly in accordance with the rules of interpretation. However, the actions of a taxpayer may be in accordance with provisions of the treaty and the domestic law of the contracting states but at the same time contravene the purpose of the treaty. Thus, according to that approach, a taxpayer who violates the purpose of the tax treaty also abuses it.²²

States do not have to extend benefits under a tax treaty in case the transaction is abusive.²³ However, uncertainty remains regarding the definition of abusive situations.²⁴ Different terms are generally used to define the result of the strive of the taxpayer to reduce taxation.²⁵ Tax avoidance is defined in the national law of different states.²⁶ It must be distinguished from tax evasion.²⁷ In general, tax evasion refers to illegal arrangements where the liability to tax is hidden or ignored.²⁸ The difficulties often arise when distinguishing between tax avoidance and tax planning. The principle of freedom of contract in general allows taxpayers to structure their affairs in order to lower their tax liability.²⁹ Tax avoidance is generally referred to as a conduct, which aims to reduce the tax liability of a taxpayer. The arrangement could be legal but, nevertheless, be incompatible with the object of the law.³⁰ Tax planning constitutes the structuring of the affairs of a taxpayer with the aim to minimize the tax liability.³¹ Unlike the concept of tax avoidance, the concept of tax planning is acceptable.³² Aggressive tax planning is a concept that originated from the US, where it was described as a tax planning with a structure that is incompatible with the spirit or purpose with fiscal rules.³³ Regarding the meaning of acting in accordance with the spirit of the law, the OECD report on cooperative tax compliance, included in the 2011 review of the OECD Guidelines for Multinational Enterprises, was described as follows:

“In particular, enterprises should comply with both the letter and the spirit of the tax laws and regulations of the countries in which they operate. Complying with the spirit of the law means discerning and following the intention of the legislature. It does not require an enterprise to make payment in excess of the amount legally required pursuant to such an interpretation”.³⁴

²² Weeghel, (1998), p. 97.

²³ OECD (2015), *Model Tax Convention on Income and on Capital 2014 (Full version)*, OECD Publishing, Commentary on Article 1, para. 9.4.

²⁴ Poulsen, *Intertax* Vol. 41 Issue 4 (2013), p. 231.

²⁵ Hilling (2016), p. 70.

²⁶ *Ibid*, p. 69.

²⁷ *Ibid*, p. 71.

²⁸ Cf. "Evasion", OECD Glossary of Tax Terms.

²⁹ Russo (2007), p. 51.

³⁰ Cf. "Avoidance", OECD Glossary of Tax Terms.

³¹ Cf. "Tax Planning", OECD Glossary of Tax Terms.

³² Russo (2007), p. 53.

³³ Carrero & Seara, *Intertax* Vol. 44 Issue 3 (2016), p. 210.

³⁴ OECD (2013), *Co-operative Compliance: A Framework: From Enhanced Relationship to Co-operative compliance*, OECD Publishing, p. 48.

The three main strategies that combat unintended double non taxation are national rules on tax avoidance and the insertion of special rules and interpretation of tax treaties. The intention of inserting special rules in tax treaties is to prevent applications of tax treaties resulting in double non-taxation, which is commonly achieved through the concept of treaty shopping.³⁵

To be granted a tax treaty benefit, Article 1 of the OECD Model requires that a person must be a resident of one of the contracting states, as defined in Article 4 of the OECD Model. The concept of treaty shopping refers to arrangements where a person not resident in a contracting state attempts to be granted benefits that a tax treaty grants to its own residents. Thus, residents of third states gain indirectly access to the benefits of a tax treaty between two contracting states.³⁶ For instance, a tax treaty is concluded between state A and state B that grants companies incorporated in one of the contracting states, with regard to income derived from the other state, exemption from withholding taxes at the source state. A resident in state C, who has no beneficial tax treaty with state B, incorporates a subsidiary in state A in order to gain access to the benefits in the tax treaty between state A and state B.³⁷ Granting treaty benefits in such situations “would frustrate the bilateral and reciprocal nature of tax treaties”.³⁸

While individuals are required to establish a real social and economic presence to become a resident of a state for tax purposes, the tax residence of corporations can be established with no economic presence in that state.³⁹ Thus, in order for corporations to be considered as a resident, a formal nexus is sufficient.⁴⁰ Therefore, concerns regarding treaty shopping focuses on entities rather than individuals.⁴¹ Economic substance, however, will be an important factor under the tie- breaker rule in Article 4(3) of the OECD Model in case a corporation is considered to have a residence in both contracting states.⁴² Article 4(3) of the OECD Model states that in case the corporation is a resident in both contracting states, it shall be deemed to be resident in the state where its place of effective management is situated. As a consequence, a letterbox company without further substance may have difficulties in claiming that its place of residence is in the state in which it has been incorporated.⁴³

³⁵ Hilling (2016) p. 44.

³⁶ OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, Action 6- 2015 Final Report (OECD Publishing 2015), p. 17. References are subsequently made to Action 6- Final Report.

³⁷ Petkova, *Intertax* Vol. 32 Issue 11 (2004), p. 544.

³⁸ OECD (2014), *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, p.31.

³⁹ Duff, *SSRN Electronic Journal* (2010), p.3.

⁴⁰ Perdelwitz (2015), p.301.

⁴¹ Duff, *SSRN Electronic Journal* (2010), p.3.

⁴² Perdelwitz (2015), p. 301.

⁴³ *Ibid.*, p. 301 f.

2.2 OECD and BEPS

Globalisation is in general considered beneficial for domestic economies as it boosts trade and increases direct foreign investments in many countries.⁴⁴ It has since a long time been recognised that overlaps as a result of the interaction of domestic tax systems may lead to double taxation. Principles were developed by the League of Nations in the 1920' s to address double taxation, from which many of international and domestic rules originate.⁴⁵ While countries are sovereign to establish their own tax rules, they are committed to eliminate double taxation to minimise trade distortions and obstacles to economic growth.⁴⁶ However, the interaction of domestic tax rules may, as mentioned in chapter 2.1, also result in gaps that provide opportunities to reduce taxation on income in a way not in accordance with the policy objectives of domestic tax rules and international standards.⁴⁷

A fundamental policy issue has been recognised, as international common principles have not kept pace with changes in the business environment. Domestic legislation for international taxation was developed in an economic environment with a lower degree of economic activities across borders.⁴⁸ Issues arise when practices are performed that artificially shifts taxable income from the activities to which the profits relate. Hence, income from cross-border activities may go untaxed or be lowly taxed anywhere.⁴⁹

Furthermore, weaknesses of the rules in force have created opportunities for base erosion and profit shifting, why confidence in the system must be restored and profits must be taxed where economic activities take place and the value is created.⁵⁰

In order to address BEPS issues, OECD initiated in 2013 an Action Plan on the initiative of the G20 finance ministers.⁵¹ BEPS mainly consists of multinational enterprises moving profits to a location where they are subject to a lower tax and expenses to a higher tax jurisdiction.⁵² Such conducts constitute a threat to the national tax sovereignty.⁵³

The Action Plan, consisting of 15 actions, was identified along three main pillars; '[...] introduction of coherence in the domestic rules affecting cross-border activities, increasing the substance requirement and improving transparency and certainty'.⁵⁴ Moreover, the BEPS project aims to prevent

⁴⁴ OECD, *Action Plan on Base Erosion and Profit Shifting*, (OECD Publishing 2013), p. 8.

⁴⁵ OECD, *Addressing Base Erosion and Profit Shifting*, (OECD Publishing 2013), p.5.

⁴⁶ OECD, *Action Plan on Base Erosion and Profit Shifting*, (OECD Publishing 2013), p. 9.

⁴⁷ OECD, *Addressing Base Erosion and Profit Shifting*, (OECD Publishing 2013), p.5.

⁴⁸ Ibid.

⁴⁹ OECD *Action Plan on Base Erosion and Profit Shifting*, (OECD Publishing 2013), p. 10.

⁵⁰ Action 6- 2015 Final Reports, p.3.

⁵¹ Ibid, p.11.

⁵² OECD *Addressing Base Erosion and Profit Shifting*, (OECD Publishing 2013), p.39.

⁵³ Hilling (2016), p.38.

⁵⁴ Action 6- Final reports, 2015, p.3.

the granting of treaty benefits resulting from the set up of international corporate structures with the sole purpose to be granted benefits of the applicable tax treaties. Hence, the measures proposed by OECD relate to a large extent to the level of genuine economic activity of a corporate structure.⁵⁵ The final reports were delivered on 5th of October 2015.⁵⁶

The European Commission has launched a Tax Transparency Package in order to combat corporate tax avoidance and harmful tax competition within the EU.⁵⁷ On 21st of June 2016, the Council agreed on a draft directive to address tax avoidance practices used by large corporations. The directive belongs to a January 2016 package of Commission proposals to fight tax avoidance of corporations. Furthermore, the package builds on the OECD Action Plan to tackle BEPS. Furthermore, since all Member States of the EU are not members of the OECD, the directive will ensure that the BEPS measures will be implemented within the EU.⁵⁸

2.3 BEPS Action Plan 6

Action 6 aims to prevent treaty abuse, in particular treaty shopping, which is recognised as one of the most important BEPS concerns.⁵⁹ It consists of three different areas. Section A intends to “prevent the granting of treaty benefits in inappropriate circumstances” by developing model treaty provisions and recommendations regarding the construction of domestic rules. A minimum standard to combat treaty shopping should be included in the OECD Model. However, the model provisions offer flexibility as they need to be adapted to the characteristics of each country and the circumstances regarding negotiations of tax treaties. For instance, constitutional restrictions or EU law may prevent some countries from implementing the exact wording of a model provision. Section B clarifies that tax treaties do not intend to be used to create opportunities to double non- taxation. Section C recognises tax policy considerations to be considered by countries before concluding tax treaties with other countries.⁶⁰

To deal with treaty shopping strategies through new treaty anti- abuse rules, as included in the work of section A, a three-pronged approach is recommended. First, in tax treaties concluded between different states a clear statement will be included that the states intend to avoid to create opportunities for low or non taxation, including through treaty shopping strategies. As a second recommendation, a limitation- on- benefit (LOB) rule, which constitutes a specific anti- abuse rule, will be included in the

⁵⁵ Perdelwitz (2015), p. 294.

⁵⁶ Panayi, IBFD Vol. 70 No. 11 (2016) No. 11, p. 629.

⁵⁷ European Commission- Press Release, *Combatting corporate tax avoidance: Commission presents Tax Transparency Package*.

⁵⁸ Council of the European Union, *Corporate Tax Avoidance: Council agrees its stance on anti-avoidance rules*.

⁵⁹ Action 6- 2015 Final report, p. 9.

⁶⁰ Ibid, p. 13.

OECD Model. The LOB rule limits the possibility for entities to obtain treaty benefits, as they are required to satisfy certain conditions in order to ensure a sufficient link between the entity and the state of residence. The third recommendation constitutes a more general anti-abuse provision (“PPT rule”) based on the principal purposes test, which is the principal purposes of transactions or arrangements, to be included in the OECD Model. The PPT rule will cover situations of treaty shopping arrangements not covered by the LOB rule.⁶¹ Thus, an application of the general anti-abuse rules would not preclude specific avoidance techniques in tax treaties.⁶²

However, the implementation of an LOB rule and a PPT rule is not sufficient to address treaty issues. Furthermore, domestic law also needs to be amended. The main intention of the work that aims to prevent cases where a person tries to use benefits by abusing provisions of domestic law is to safeguard that treaties do not prevent specific domestic law provisions that would prevent these situations. A guiding principle is already recognised in the Commentary of Article 1 in the OECD Model Convention, which will be included in the OECD Model through a general anti-abuse rule. According to the guiding principle, a benefit of a tax treaty should be denied where the main purpose for entering a transaction or arrangement was to ensure such benefits in order to obtain a favourable treatment.⁶³

2.4 The LOB clause

Hence, an LOB clause aimed at treaty shopping will be included in the OECD Model.⁶⁴ It has been incorporated in nearly the entire treaty network concluded by the US and several other countries.⁶⁵ However, the LOB provisions and the Commentary on these provisions presented in the OECD Final Report will be reviewed in the light of the comments received on the new LOB clause included at May 2015 in the model treaty of the US.⁶⁶

The LOB clause reflects the intention of contracting states to abolish double taxation without generating possibilities for non taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping.⁶⁷ If a state is aware that possibilities exist for residents to indirectly access the benefits of treaties concluded by another state, it may have a reduced interest in granting reciprocal benefits to residents of that other state through the conclusion of tax treaties. Additionally, indirectly obtained benefits may

⁶¹ Ibid, p. 18.

⁶² OECD (2015), *Model Tax Convention on Income and on Capital 2014 (Full version)*, OECD Publishing, Commentary on Article 1, p. 9.6.

⁶³ Action 6, Final report 2015, p. 19; OECD (2015), *Model Tax Convention on Income and on Capital 2014 (Full version)*, OECD Publishing, Commentary on Article 1, paras 9.5, 22, 22.1 and 22.2 & Hilling (2016), p. 38 f.

⁶⁴ Action 6- 2015 Final Report, p. 20.

⁶⁵ Bates et al., *Intertax* Vol. 41 Issue 6&7 (2013), p.395.

⁶⁶ Action 6- 2015 Final Report, p.20.

⁶⁷ Ibid, p. 21.

be inappropriate given the nature of the tax system of the former state. For instance, the situation may occur where that state does not levy any tax on a certain type of income and the residents benefit from a tax treaty between two other contracting states that grant a reduction or elimination of source taxation for that type of income, designed on the assumption that the two contracting states would tax such income.⁶⁸

Compared to the PPT rule, which requires a case-by-case analysis based on what can be considered as one of the principal purposes of transactions or arrangements, the LOB rule provides certainty as it is based on objective criteria.⁶⁹ However, the construction is technical and “rule-based”.⁷⁰ As a consequence, the LOB clause is dense and complex.⁷¹

In order to be granted benefits under an LOB clause, a resident of a contracting state must, as a main rule, constitute a “qualified person”. Thus, the LOB clause aims to limit the application of Article 1 in the OECD Model, which, states that the Convention applies to a person who is a resident of a contracting state.⁷² The Commentary of Article 1 in the OECD Model recommends states to implement an LOB clause.⁷³ Furthermore, OECD proposes to migrate the LOB clause from the Commentary to the OECD Model.⁷⁴ To prevent the situation where the granting of treaty benefits has been based on residency of the party claiming the benefits and, thus, opened up opportunities for tax treaty abuse, the LOB clause provides requirements that must be satisfied for a person to be granted certain tax treaty benefits. An entity other than an individual or governmental entity will need to provide supplemental connections to the country of residence.⁷⁵ The reason is that abuse is less common for individuals or governmental entities.⁷⁶ Hence, the taxpayer is required to prove that the purpose for becoming a resident of a contracting state is not to obtain benefits of the treaty concluded by that state.⁷⁷ However, the LOB clause does not refer to the intention of a taxpayer. Instead, objective tests must be satisfied in order to grant the taxpayer tax treaty benefits. Thus, this system prevents residents of a third state to misuse a tax treaty by establishing a conduit company in one of the other contracting states to gain access to and be granted benefits from that treaty. If any of the objective tests is met, the taxpayer is deemed to have a sufficiently strong nexus to the other contracting state. Hence, the

⁶⁸ Ibid, p. 22.

⁶⁹ Action 6- 2015 Final Report, p. 19.

⁷⁰ Broe & Luts, *Intertax* Vol. 43 Issue 2 (2015) p. 128.

⁷¹ Fleming, *Intertax* Vol. 40 Issue 4 (2012), p. 245.

⁷² Action 6- 2015 Final Report, p. 23; OECD *Model Tax Convention on Income and on Capital* (OECD Publishing 2014), Article 1.

⁷³ OECD (2015), *Model Tax Convention on Income and on Capital 2014 (Full version)*, OECD Publishing, Commentary on Article 1, para 20.

⁷⁴ Broe & Luts, *Intertax* Vol. 43 Issue 2 (2015) p. 128.

⁷⁵ Bates et al., *Intertax* Vol. 41 Issue 6&7 (2013), p.395.

⁷⁶ Broe & Luts, *Intertax* Vol. 43 Issue 2 (2015) p. 128.

⁷⁷ Vogel (2015), p. 63.

taxpayer will gain access to treaty benefits nonetheless any absence of a proper business connection and the intention of a specific transaction.⁷⁸

Furthermore, it would constitute a reasonable effort to test the sufficiency of a personal and an economic nexus with the state that claims jurisdiction to tax.⁷⁹ Moreover, the conditions that must be met are based on the legal nature, ownership in, and general activities of the entity and aims to ensure a sufficient link between the entity and its state of residence.⁸⁰ The LOB clause could limit the utilization by multi national enterprises of the resident tests provided in Article 4(1) OECD Model, especially regarding companies that easily could become residents of a state based on largely formal requirements.⁸¹ Thus, the intention of LOB clauses is to affect the subjective scope of a tax treaty.⁸² To conclude, an LOB clause restricts the general principle stating that a tax treaty applies to residents of a contracting state since only qualified persons gain access to tax treaty benefits.⁸³

2.5 Access to Treaty Benefits

According to paragraph 1 of the LOB clause a resident of a contracting state shall not be entitled to treaty benefits unless it constitutes a “qualified person” under paragraph 2 or unless benefits are granted under the provisions of paragraph 3, 4 or 5.⁸⁴ Treaty benefits generally consist of distributive and relief rules of the treaty, limiting the taxing right of the contracting states.⁸⁵

Paragraph 2 recognises what constitutes a “qualified person”, which is automatically entitled to all benefits under the tax treaty.⁸⁶ Further, situations where a resident would be considered a “qualified person” cover “a) individuals, b) Contracting States, its political subdivisions and entities that it wholly owns, c) certain publicly- listed entities and their affiliates, d) certain charities and pension funds, e) other entities that meet certain ownership requirements f) certain collective investment vehicles”.⁸⁷

Paragraph 3 entitles a person treaty benefits although it does not constitute a “qualified person” under paragraph 2. The condition that must be fulfilled is that the item of income in question is derived in connection with the active conduct of a trade or business in the state of residence of the person. Certain entities owned by residents of third states are according to the “derivative benefits” rule under paragraph 4 granted treaty benefits under the condition

⁷⁸ Perdelwitz (2015), p. 308 f.

⁷⁹ Wardzynski, IBFD Vol. 68 No. 9 (2014), p. 474.

⁸⁰ Panayi, IBFD Vol. 70 No. 11 (2016), p. 640.

⁸¹ Wardzynski, IBFD Vol. 68 No. 9 (2014), p. 474.

⁸² Broe & Luts Intertax Vol. 43 Issue 2 (2015), p. 128; Borrego, 2006, p.92.

⁸³ Perdelwitz (2015), p. 308 f.

⁸⁴ Action 6- 2015 Final Report, p. 23.

⁸⁵ Broe & Luts Intertax Vol. 43 Issue 2 (2015) p. 128; OECD Model Tax Convention on Income and on Capital, Condensed Version 2014 (OECD Publishing 2014), Articles 6-23.

⁸⁶ Broe & Luts Intertax Vol. 43 Issue 2 (2015), p. 129.

⁸⁷ Action 6- 2015 Final Report, p. 21.

that equivalent benefits would have been granted should they have invested directly. Paragraph 5 allows the competent authority of a contracting state to allow treaty benefits where other provisions of the LOB clause would otherwise deny such benefits.⁸⁸

2.5.1 Publicly-traded Test

The subparagraph 2 c) in the LOB clause recognises a resident publicly - traded company as a qualified person, and thus entitled to tax treaty benefits, if, throughout the taxable period that includes that time

- i) “the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:
 - A) its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting States of which the company or entity is a resident, or:
 - B) the company’s or entity’s primary place of management and control is in the Contracting State of which it is a resident, or:
- ii) at least 50 per cent of the aggregate voting power and value of the shares (and at least 50 per cent of any disproportionate class of shares) in the company or entity is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subdivision i) of this subparagraph, [provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State.]”⁸⁹

Furthermore, subdivision i) applies to companies and entities that are publicly- traded while subdivision ii) applies to subsidiaries of companies and entities that are publicly- traded. The publicly- traded test identifies that since shares of publicly- traded companies and of some entities in general are widely- held, these entities are unlikely to be established for the purpose of treaty shopping. Although a publicly- traded company or entity may be technically resident in a certain state, it may not have sufficient connection to justify the granting of treaty benefits. However, such a sufficient relationship may be established by the fact that the shares of the publicly-traded company or entity are primarily traded in recognised stock exchanges located in the residence state of the company or entity. As the globalisation of financial markets entails that shares of publicly- listed companies often are traded on foreign stock markets, a sufficient connection may also be established if the company or entity is predominantly managed or controlled in its residence state.⁹⁰ The trading requirement can be satisfied by trading of issued shares on any recognised exchange situated in whichever state. Furthermore, trading on recognised stock exchanges may be aggregated to fulfil the requirement. Hence, a company or entity could therefore fulfil the requirement if its shares are regularly traded, in whole or in part, on a

⁸⁸ Action 6- 2015 Final Report, p. 23.

⁸⁹ Ibid, p. 26.

⁹⁰ Ibid, p.26 f.

recognised stock exchange located in the other contracting state. It should be noted that states may modify subdivision (i)A) to cover, for instance, shares of a company that are traded in other Member States of the EU.⁹¹

For instance, if a company resident in a contracting state is fully owned by a parent company also resident in the same contracting state, it would qualify for treaty benefits if the principal class of shares (and any disproportionate class of shares) of the parent company are regularly and primarily traded on a recognised stock exchange in that contracting state. However, if the parent company instead constitutes a resident of a third state, the subsidiary would not be granted benefits under subdivision ii).⁹²

Thus, a publicly- traded company is deemed to have a sufficient connection, in order to obtain benefits under a tax treaty, with the state in which its shares are primarily and actively traded. Although one assumption may be that the majority of the shareholders are residents in that state, there are in reality still many of the shareholders not resident in the state in which the trading takes part. On the other hand, as publicly- traded companies usually are subject to security laws, they do in general not constitute tools for treaty shopping.⁹³

2.5.2 Ownership Test and Base Erosion Test

Subparagraph 2 e) applies to any form of legal entity resident of a contracting state and provides an additional opportunity to qualify for treaty benefits. The ownership and base erosion test is a two- part test. Hence, the resident person must fulfil both parts in order to be granted treaty benefits.⁹⁴

As a qualified person entitled to benefits is a person other than an individual, if

- i. “[...]on at least half the days of the taxable period, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph a), b) or d), or subdivision i) of paragraph c), of this paragraph own, directly or indirectly, shares representing at least 50 per cent of the aggregate voting power and value (and at least 50 per cent of any disproportionate class of shares) of the person, [provided that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State],and
- ii. less than 50 per cent of the person’s gross income for the taxable period, as determined in the person’s Contracting State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b) or d), or subdivision i) of paragraph c), of this paragraph in the form of payments that are deductible for purposes of taxes covered by this Convention in the person’s Contracting State of residence, (but not including

⁹¹ Ibid, p. 27.

⁹² Ibid, p. 28.

⁹³ Bates et al., Intertax Vol. 41 Issue 6&7 (2013), p.395.

⁹⁴ Action 6- 2015 Final Report, p. 30.

arm's length payments in the ordinary course of business for services or tangible properties).⁹⁵

Furthermore, in order to satisfy the test, at least 50 per cent of the equity holders are required to be "qualified persons". An additional requirement is that less than 50 per cent of the gross income is being paid to persons other than "qualified persons" in "the form of deductible payments outside the ordinary course of business". Thus, if the ultimate persons who economically own the company are residents of the company's state of residence, the company should enjoy treaty benefits in that state. Equity owners of a company are beneficiaries why the ownership part of the test focuses on equity or beneficial ownership. However, lenders in a non-equity relationship can also enjoy benefits of a fruitful enterprise, which the base erosion part of the test focuses on.⁹⁶

Regarding the ownership prong, the purpose is to test whether there is a sufficiently strong connection with the residence state. However, it could be questioned whether a sufficiently strong nexus would not be established although a person that is qualified to treaty benefits owns less than 50 per cent of the aggregate voting power and value of the company. An example is provided to illustrate the problem.⁹⁷

A company XCo, resident in country X, owns 40 per cent of the stock of RCo, a company resident in country R. Company ACo owns the remaining 60 per cent. 60 per cent of the shares in ACo are owned by individual residents in country R. RCo invests in country S. In order to determine the ownership prong of qualified persons, which are the individuals resident in country R, the 60 per cent ownership of stock of RCo owned by ACo is multiplied by the 60 per cent ownership of stock of ACo owned by individual residents of country R. The result will be that qualified persons indirectly own only 36 per cent of the shares, why RCo not fulfils the ownership test. However, as RCo is controlled by a shareholder that is in itself controlled by qualified residents, it could be argued that the ownership part should be satisfied. It is unlikely that XCo, which constitutes a minority shareholder, would use RCo in order to be covered by the treaty concluded between country R and country S.⁹⁸

An example regarding the base erosion prong will also be provided to illustrate when a company is not deemed to satisfy the base erosion test.

A company RCo, resident in country R, pays 60 per cent of its gross income in the form of payments deductible outside the ordinary course of business to company ACo, a company that is also a resident in country R and which is qualified to treaty benefits under the ownership/base erosion test. The payment of RCo to ACo constitutes all of ACo's gross income. The

⁹⁵ Action 6- 2015 Final Report, p. 30.

⁹⁶ Bates et al., *Intertax* Vol. 41 Issue 6&7 (2013), p.395.

⁹⁷ Bates et al., *Intertax* Vol. 41 Issue 6&7 (2013), p. 397.

⁹⁸ *Ibid.*

remaining 40 per cent of the gross income of company RCo is paid to persons not resident in country R or country S in the form of deductible payments outside the ordinary course of business. ACo pays 40 per cent of its gross income to persons not residents of country R or country S in the form of payments deductible outside its ordinary course of business. Furthermore, 64 per cent of the gross income of RCo is effectively constituting deductible payments to persons not residents of country R or country S. As company ACo is entitled to benefits under the base erosion/ownership test, it does not constitute a certain qualified person to which more than 50 per cent of the gross income of a company can be paid in “the form of deductible payments other than in the ordinary course of business”. Consequently, the ownership prong is not satisfied and indirect base erosion is prevented.⁹⁹

2.5.3 Active Business Test

A non-qualified resident of a contracting state satisfies the active business test, and will thus be entitled benefits with regard to an item of income derived from the other contracting state, under the circumstances that:

- A) The resident is engaged in the active conduct of a business in the state of residence (other than the business of making or managing investments for the resident’s own account, unless these investments are banking, insurance or securities activities carried on by a bank or insurance enterprise or registered securities respectively) and the income derived from the other contracting state is derived in connection with, or is incidental to, that business.
- B) In case an item of income is derived from a business activity conducted by that resident in the other contracting state, or from an associated enterprise in that state, the business activity carried on by the resident in the first-mentioned state is substantial in relation to the business activity carried on by the resident or associated enterprise in the other contracting state.¹⁰⁰

Paragraph 3 provides an alternative test and will provide treaty benefits in situations otherwise denied because the entity is not considered as a “qualified person” according to paragraph 2. Furthermore, a company resident in a contracting state may be granted treaty benefits regarding income connected to an active business performed in its residence state. The paragraph identifies that, regardless of the nature and ownership of the entity, where an entity resident in a contracting state actively carries on business activities from that state, including activities performed by connected persons, and derives income from the other contracting state in connection with, or incidental to, such business activities, granting treaty benefits with respect to such income will not give rise to treaty shopping issues.¹⁰¹

⁹⁹ Ibid, p. 398; Action 6- 2015 Final Report, p. 30.

¹⁰⁰ Action 6- 2015 Final Report, p. 36.

¹⁰¹ Ibid, p. 37.

Furthermore, in order for a taxpayer to be accorded treaty benefits under paragraph 3, two conditions must be satisfied. The person must be engaged in the active conduct of a business in its state of residence and the payment for which the benefits are sought must be related to the business. Furthermore, an additional condition that the business be substantial in size in relation to the activity performed in the source state and generates the income must in certain situations be met.¹⁰²

Regarding the condition that an item of income is required to be derived in connection with a business, the condition is satisfied if the income producing activity of the business “forms part of” or is “complementary to” the business conducted in the residence state by the income recipient. If the business activities performed in the source state and in the residence state constitute design, manufacture or sale of the same type of products, a business activity is in general considered to form part of the same business. Furthermore, the line of business in the residence state may be upstream, downstream or parallel in relation to the activity in the source state. For instance, company BCo resident in state B is 100 per cent owned by company ACo, resident in state A. ACo is engaged in an active manufacturing business of state A. BCo distributes the products of ACo in state B. The business activity performed by the two companies involves the same products, why the distribution business of BCo is considered to form part of ACo’s manufacturing business.¹⁰³

2.5.4 Derivative benefits relief

A derivative benefit test is set out in paragraph 4 and has the following wording:

“A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention, if, at the time when that benefit would be accorded:

- A) at least 95 per cent of the aggregate voting power and value of its shares (and at least 50 percent of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary, and
- B) less than 50 per cent of the company’s gross income, as determined in the company’s State of residence, is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of payments (but not including arm’s length payments in the ordinary course of business for services or tangible property) that are deductible for the purposes of the taxes covered by this Convention in the company’s State of residence.”¹⁰⁴

Hence, the “derivative benefits” test refers to tax treaties between the other contracting state and the country where the owners of the entity are

¹⁰² Ibid.

¹⁰³ Action 6- 2015 Final Report, p. 37 f.f.

¹⁰⁴ Ibid, p. 42.

residents.¹⁰⁵ For a company to qualify, an ownership and a base erosion test must be satisfied. Furthermore, certain companies that are, in general, residents of a contracting state are entitled treaty benefits if the owner of the company would have been entitled to at least the same benefit if the owner had been the direct recipient of the income.¹⁰⁶

Regarding the base erosion test, it is the same as in subparagraph e) (ii) of paragraph 2, with the difference that the test under the derivative relief test focuses on base eroding payments to persons not being equivalent beneficiaries.¹⁰⁷

There are two ways in which a person may qualify for an “equivalent beneficiary”. Thus, if a person is entitled to equivalent benefits according to a tax treaty concluded between the source state and a third state in which the person is a resident, the person may be an “equivalent beneficiary”. The person must in such case be granted equivalent benefits under an applicable tax treaty. Further, with respect to dividends, interests and royalties, the person must be entitled to a rate of tax that is “at least as low as” the tax rate that would apply under the Convention to such income.¹⁰⁸

Furthermore, the rates to be compared are the rates of tax that the source state would have imposed if the resident of the other contracting state who is a qualified person were the beneficial owner of the income and the tax rate the source state would have imposed if the third state resident received the income directly from the source state.¹⁰⁹

However, the “at least as low as” requirement might in some cases be hard to justify on policy grounds. For instance, the company XCo, resident in state X, owns 100 per cent of the stock of RCo, a company resident in state R. SCo, resident in state S, pays interest to RCo. Without the application of a tax treaty between state R and state S, the interest would be subject to 30 per cent withholding tax in country S. However, the tax treaty concluded between country R and country S provides a zero rate payment of taxes on interest, which is lower than the tax treaty concluded between country X and country S would provide, which is 5 per cent. As the “at least as low as” requirement is not satisfied, there is a risk that RCo would be subject to the domestic tax rate of 30 per cent.¹¹⁰

2.5.5 Competent Authority Relief

The LOB provisions described above allow direct access to treaty benefits. However, the competent authority may grant treaty benefits under certain circumstances to prevent situations where taxpayers acting in good faith are

¹⁰⁵ Bates et al., *Intertax* Vol. 41 Issue 6&7(2013),p. 396.

¹⁰⁶ Action 6- 2015 Final Report, p.42.

¹⁰⁷ Action 6- 2015 Final Report, p. 43.

¹⁰⁸ *Ibid*, p. 51 f.

¹⁰⁹ *Ibid*, p. 52 f.

¹¹⁰ *Ibid*, p.401.

not allowed treaty benefits.¹¹¹ Furthermore, paragraph 5 of the LOB clause provides a resident of a contracting state the opportunity to request the competent authority of that state to grant benefits in case the resident has not been entitled benefits under the objective tests in paragraph 1 through 4.

The benefits will be entitled if the competent authority determines, upon request on the resident, “[...] that the establishment, acquisition or maintenance of the resident and the conduct of its operation [...]” are considered as not having the granting of such benefits as one of its principal purposes. Thus, the competent authority may grant a resident having a substantial relationship with its resident state treaty benefits taking into account all relevant facts and circumstances where the allowance of benefits would not otherwise be contrary to the purposes of the Convention.¹¹² A detailed list of all facts and circumstances taken into account regarding the determination is not provided, however those facts include the history, structure, ownership and operations of the requesting resident. Additionally, the competent authority takes into consideration whether the resident entity has been established in the residence state for a long time and recently has been acquired for non- tax reasons by non- residents, whether substantial business activities are carried on by the resident, whether the income of the resident for which the benefits are sought is subject to double taxation and if the establishment causes non- taxation or low taxation with respect to the income.¹¹³ A conclusive proof of intent is not required to be established, but the conclusion that “[...] none of the principal purposes for the establishment, acquisition, or maintenance of the person and the conduct of its operation [...]” was to be granted benefits under the convention must be based on an objective analysis.¹¹⁴

A broad discretion is provided the competent authority. As long as the discretion has been exercised in accordance with the requirements that all relevant facts and circumstances are being considered before reaching a decision, the decision will not be considered as resulting in taxation not in accordance with the provisions of the Convention. Furthermore, this requirement ensures that the competent authority will consider each request on its own merits. Additionally, the competent authority is required to consult the decision with the competent authority of the other contracting state. The reason is to ensure that the similar cases are treated in a consistent manner and, thus, can justify their decision on basis on the relevant facts and circumstances of the particular case.¹¹⁵

To conclude, the competent authority relief constitutes a “safety valve” which provides the competent authority with the possibility to grant treaty benefits to arrangements that are bona fide commercial.¹¹⁶ For instance, if

¹¹¹ Borrega (2006) p. 214.

¹¹² Action 6- 2015 Final Report, p. 43.

¹¹³ Ibid, p. 46.

¹¹⁴ Ibid, p. 44.

¹¹⁵ Ibid, p. 45.

¹¹⁶ Wardzynski, Bulletin for International Taxation Vol. 68 No. 9 (2014), p. 475.

the facts are the same as in the example under section 1.2.4, and company RCo fails to fulfil the derivative benefits test, the competent authority may instead provide RCo with a zero rate on the interest.¹¹⁷

¹¹⁷ Bates et al., (2013), 41 Intertax, Issue 6&7, p. 401.

3 The impact of EU law

3.1 General remarks

This chapter will provide general remarks of the impact of the fundamental freedoms on the Member States within the EU. The CJEU follows three steps in order to determine whether a national measure is incompatible with the right to free movement. First, it must be assessed whether the taxpayer has exercised any of the rights provided by the articles of the free movements. Second, it must be determined whether the measure constitutes an obstacle to the free movement. If it does, it must be assessed whether the measure can be justified and complies with the principle of proportionality.¹¹⁸

The concerns that the LOB clause must be in compliance with EU law has been recognised by the OECD in the follow up work of BEPS Action 6.¹¹⁹ EU law may set restrictions on the actions suggested in BEPS. In order to implement the BEPS Actions in an efficient manner, EU law must be taken into account; otherwise the Actions can only be implemented partly, outside the EU context.¹²⁰

The reason why the LOB clauses in the context of BEPS Action 6 would constitute an issue with regard to the fundamental freedoms is because the LOB clause creates a difference in treatment between qualifying and non-qualifying residents.¹²¹ Since non qualifying residents have no possibility to claim treaty benefits under the same conditions as qualifying residents, they are in a disadvantageous situation.¹²² For taxpayers who do not pass the objective tests, the LOB clause creates a less favourable treatment.¹²³ LOB clauses are developed to “prevent the granting of treaty benefits in inappropriate circumstances and to curb double non taxation”.¹²⁴ However, intended or acceptable double non taxation caused by national tax systems is not contrary to EU law as long as it does not constitute harmful tax competition or state aid.¹²⁵ EU law does not provide any criteria in order to eliminate double taxation.¹²⁶ Furthermore, the Member State of residence is not obliged to prevent disadvantages arising from the exercise of competences attributed by the Member States.¹²⁷ As long as it does not

¹¹⁸ Case C-55/94 *Gebhard*, para. 37; Hilling, (2013), 41 *Intertax* Issue 5, p. 296.

¹¹⁹ OECD, *Discussion Draft: Prevent the Granting of Treaty Benefits in Inappropriate Circumstances*, (OECD 2014), p. 8.

¹²⁰ Kemmeren, *EC Tax Review* Vol. 23 Issue 4, (2014), p. 190 f.

¹²¹ Debelva et. al., *EC Tax Review* Vol. 24 Issue 3 (2015), p.134.

¹²² *Ibid*, p. 135.

¹²³ Debelva et. al., *EC Tax Review* Vol. 24 Issue 3 (2015), p. 132.

¹²⁴ Panayi, *Bulletin for International Taxation* Vol. 70 No 1/2 (2016), p.104.

¹²⁵ Helminen, *European Taxation* Vol. 53 No 7, (2013),p. 307.

¹²⁶ Case C- 128/08 *Damseaux*, para 33; Case C- 513/04 *Kerckhaert and Morres*, para 22; Case C- 298/05 *Columbus Container Services*, para. 45.

¹²⁷ Case C- 128/08 *Damseaux*, para 34.

constitute discrimination, juridical double taxation is not incompatible with EU law. To this effect, Member States are not required to amend their domestic tax systems to eliminate double taxation. It could therefore be questioned if the same reasoning should not be applicable regarding the issue of double non taxation.¹²⁸

Regarding LOB clauses, it has been argued that they are in breach of the free movement of establishment and the free movement of capital. The question is whether Member States of the EU could include LOB clauses in tax treaties concluded between them or with a third state.¹²⁹ However, as the focus of this thesis is not to analyse the compatibility of the LOB clause with the fundamental freedoms, but with the principle of MFN treatment, the reasoning of the CJEU when determining the compatibility with EU law will only shortly be reviewed.¹³⁰

The sovereignty of the Member States within the field of direct taxation is in conflict with the aim of establishing an internal market within the EU.¹³¹ The Member States are free to conclude tax treaties with each other.¹³² However, they shall take all appropriate steps to eliminate incompatibilities with the EU law according to Article 351 of the TFEU. Since the tax system under tax treaties forms part of the legal background of a case, the CJEU must take it into account when interpreting EU law. However, it is not for the CJEU to interpret national law or to assess its application in the case at issue.¹³³

The TFEU provides provisions stipulating the abolition of obstacles regarding the free movement of goods, services, capital and persons.¹³⁴ Furthermore, the internal market should “comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured [...]”.¹³⁵ “The Member States and the Union shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources [...]”¹³⁶. Thus, economic tax neutrality should prevail meaning that taxation should not have any influence on the decisions of a person to act in a specific manner.¹³⁷

¹²⁸ Panayi, Bulletin for International Taxation Vol. 70 No 1/2 (2016), p.104.

¹²⁹ Ibid, p.105.

¹³⁰ For further reading regarding the compatibility of LOB clauses with EU law, see, *inter alia*, Kemmeren, EC Tax Review Vol. 23 Issue 4, (2014), & Panayi, Bulletin for International Taxation Vol. 70 No 1/2 (2016).

¹³¹ Schön, Bulletin for International Taxation Vol. 69 No 4/5 (2015), p. 271.

¹³² Essers et. al., (1998), p.19.

¹³³ Case C-265/04 *Bouanich*, para. 51.

¹³⁴ Ståhl et. al, (2011), p. 70.

¹³⁵ Art.26 TFEU.

¹³⁶ Art. 120 TFEU.

¹³⁷ Schön, Bulletin for International Taxation, Vol. 69 No 4/5 (2015), p. 272 & Kemmeren, EC Tax Review Vol. 21 Issue 3 (2012), p.159.

3.2 Fundamental Freedoms in general

A tax treatment in a Member State may be in conflict with the TFEU if the treatment restricts one of the freedoms that it protects. The free movement of goods is covered under Article 34 and Article 35 of the TFEU, according to which restrictions and measures with equivalent effect on imports and exports between Member States shall be prohibited. Article 21 of the TFEU covers the free movement of citizens of the EU, protecting the right to “move and reside freely” within the EU. The free movement of workers are protected by Article 45(2) of the TFEU, which “shall entail the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration, and other conditions of work and employment”. Restrictions on free movement of establishment are prohibited under Article 49(1) of the TFEU. The prohibition covers restrictions with regard to the setting up of agencies, branches, or subsidiaries by nationals of any Member State in another Member State. Restrictions on the freedom to provide or receive services are prohibited according to Article 56 of the TFEU. With regard to the freedom of capital and payments, all restrictions on capital and payments between Member States and third states are prohibited under Article 63.

The freedoms provide the right to cross- border activities and a prohibition of discrimination on grounds of nationality or origin.¹³⁸ The intention of the Member States has in general not been that the articles of TFEU would have an impact on the field of direct taxation. Furthermore, the Member States considered that the articles of TFEU would not encroach on the sovereignty of the states regarding issues of taxation.¹³⁹ However, as the CJEU has pointed out, the fact that the laws of the Member States have not been harmonized cannot justify any derogation from the right of establishment.¹⁴⁰ Consequently, although direct taxation does not fall within the competence of the EU, the powers retained by the Member States must still comply with EU law.¹⁴¹ Though LOB clauses are included in tax treaties it does not mean that they will not be subject to scrutiny, even in the case when the tax treaties are concluded between a Member State and a third country.¹⁴²

As already mentioned, LOB clauses might violate the free movement of establishment and the free movement of capital.¹⁴³

Restriction on the freedom of establishment of nationals of a Member State in the territory of another Member State is prohibited according to Article 49 of the TFEU. Thus, the prohibition applies also to “restrictions on setting- up of agencies, branches or subsidiaries by nationals of any Member

¹³⁸ Terra; Wattel (2012), p. 53.

¹³⁹ Ståhl et. al, (2011), p. 70.

¹⁴⁰ C- 270/83 *Avoir Fiscal*, para. 24.

¹⁴¹ C- 279/93 *Schumacker*, para. 21.

¹⁴² Debelva et. al., EC Tax Review Vol. 24 Issue 3 (2015), p. 134

¹⁴³ See section 3.1.

State established in the territory of any other Member State.”¹⁴⁴The use of an intermediary entity situated in a tax jurisdiction to access a more favourable tax treatment constitutes an exercise of freedom of establishment.¹⁴⁵ The freedom of establishment is exercised when a national of a Member State holds capital of a company established in another Member State and, thus, enables the definite influence over the company’s decision and allows the national to determine its activities.¹⁴⁶

As the CJEU held in, *inter alia*, the *Centros* case, the fact that a company intend to circumvent national rules and does not pursue any activity is not sufficient in order to deny the right of freedom of establishment.¹⁴⁷ Hence, as Panayi argues, the reason that corporate forum shopping has taken place within the EU with little economic substance in the establishment would not deprive the freedom of establishment.¹⁴⁸ The CJEU has thenceforth in *Cadbury Schweppes* emphasized that the fact that a national of a Member State has sought to profit from tax advantages of another Member State cannot in itself deprive the national from the rights flowing from the EU law and does not constitute abuse.¹⁴⁹ However, in order for the fundamental freedoms to apply, there must be a genuine cross border activity. In case the intermediary entity that is established in another Member State in order to be granted treaty benefits is a “complete sham”, no genuine exercise of establishment or movement of capital has taken place why the freedom of movement cannot be relied on.¹⁵⁰

It could be argued that investing indirectly in a company through another Member State entity constitutes free movement of capital. The essential part is that the person does not control the intermediary in another Member State through which it invests in a third state.¹⁵¹ Article 63 of the TFEU prohibits all restrictions on the free movement of capital between Member States and between Member States and third countries. Furthermore, restriction on movements of capital includes measures taken by Member States, which discourage residents from obtaining loans or making investments in other Member States.¹⁵² Since anti- treaty shopping provisions tend to disregard the intermediary entity and reclassify the payment as being directly made to another company, the investment may become more expensive. On this basis, it could be argued that the anti- treaty- shopping provisions constitute a restriction on the free movement of capital.¹⁵³

¹⁴⁴ Article 49 TFEU.

¹⁴⁵ Panayi, Bulletin for International Taxation Vol. 70 No 1/2 (2016), p.105.

¹⁴⁶ C- 251/98 *Baars*, para. 22.

¹⁴⁷ C- 212/97, *Centros*, para 29

¹⁴⁸ Panayi, Bulletin for International Taxation Vol. 70 No 1/2 (2016),

¹⁴⁹ C- 196/04 *Cadbury Schweppes*, paras 36 & 38.

¹⁵⁰ Panayi, Bulletin for International Taxation Vol. 70 No 1/2 (2016), p. 105.

¹⁵¹ *Ibid* p. 106.

¹⁵² C-233/09 *Dijkman- Lavaleije*, Para. 25.

¹⁵³ Panayi, Bulletin for International Taxation Vol. 70 No 1/2 (2016), p. 106.

3.3 Restriction or discrimination?

Discrimination based on nationality is prohibited according to Article 18 of the TFEU. It applies only to cross border situations and not to internal situations of a Member State as it grants the right to citizens of the EU to “move and reside freely in the territory of another Member State.”¹⁵⁴ Article 18 of the TFEU constitutes a general provision and does not limit the scope of the articles on the basic freedoms. Furthermore, it lays down a general prohibition of all grounds of nationality and applies independently only in situations governed by the EU law for which the TFEU lays down no specific rules of non discrimination.¹⁵⁵ Not only overt discrimination based on nationality but also covert forms of discrimination leading to the same result is prohibited, such as discrimination based on residence.¹⁵⁶ Thus, different treatment based on residence may indirectly result in discrimination since most of the EU residents are also nationals of a Member State within the EU.¹⁵⁷ Discrimination can arise through the application of different rules to comparable situations or the application of the same rule to different situations.¹⁵⁸ Hence, a comparability analysis is required in order to assess whether discrimination has taken place.¹⁵⁹ The situations must be objectively comparable in the light and purpose of the tax measure concerned in order for a worse treatment of a specific cross border situation compared to a specific domestic situation to be prohibited.¹⁶⁰

As the CJEU highlighted in the *Halliburton* case, if a Member State treats a national of another Member State worse than its own nationals, it constitutes discrimination.¹⁶¹ In particular, vertical discrimination is prohibited by Article 18 of the TFEU and means that nationals of the EU has the right to be treated equally to nationals of the Member State at issue.¹⁶² Furthermore, what is required is a “national treatment”. The concept of “most-favoured-nation treatment”, on the other hand, refers to the situation where a citizen A requests to be equally treated by Member State B as it treats a national of Member State C. Moreover, what differs “national treatment” from MFN treatment is the comparative standard.¹⁶³ The MFN treatment may be considered as a sort of discrimination. Regarding the comparative standard, in order to assess whether there is discrimination, a non resident is being

¹⁵⁴ C- 403/03 *Schempp*, paras. 23 & 25; Helminen, 2015, Ch.2, p.1.

¹⁵⁵ See, *inter alia*, C- 240/10 *Schulz-Delzers*, para. 29; C- 443/06 *Hollman*, para. 28; Joined Cases C- 397/98 and C-410/98 *Metallgesellschaft*, para. 38, C- 422/01 *Skandia and Ramstedt*, para. 61; C- 311/97 *Royal Bank of Scotland*, para 20; C- 251/98 *Baars*, para. 23.

¹⁵⁶ C- 175/88, *Biehl*, para. 13 & Helminen (2015), p. 1.

¹⁵⁷ Helminen (2015), p. 2.

¹⁵⁸ See, *inter alia*, C- 279/93 *Schumacker*, para 30; C-391/97 *Gschwind*, para. 21; C-80/94 *Wielockx*, para. 17, C- 383/05 *Talotta*, para. 18; C- 311/97 *Royal Bank of Scotland*, para. 26.

¹⁵⁹ Helminen, (2015), p. 3.

¹⁶⁰ C- 48/13 *Nordea Bank*, paras. 23 & 24.

¹⁶¹ C- 1/93, *Halliburton*.

¹⁶² Helminen, (2015), p. 3.

¹⁶³ Van der Linde, EC Tax Review Vol. 13 Issue 1 (2004), p.11.

compared with another non- resident.¹⁶⁴ Thus, MFN treatment prevents horizontal discrimination between citizens of different states within the EU.¹⁶⁵ The question that will be further analysed is whether Article 18 of the TFEU also prohibits horizontal discrimination. As will be revised, the standpoint of the CJEU has been somewhat unclear.

According to the case law of the CJEU, measures that do not constitute discrimination will be regarded as a restriction if they “prohibit, impede or render less attractive the exercise of that freedom [...]”¹⁶⁶ Thus, as the CJEU emphasized in the *Bosman* case, although a measure not only applies to a cross border situation but also to a domestic situation, it is prohibited if it constitutes an obstacle to the freedom to move.¹⁶⁷ In order to consider a domestic measure being a hindrance to the free movement, the measure must treat cross border situations less favourably than a comparable domestic situation.¹⁶⁸ Nowadays, the comparison criterion matters more than nationality and origin. Thus, irrespective of the nationality of the moving person, the decisive comparison has become the comparison between a cross border situation and an assumed purely domestic, comparable situation.¹⁶⁹

Overt discriminative measures are allowed solely on the grounds expressly mentioned in the TFEU. Thus, the covert or indirect discrimination has caused most attention within the field of direct taxation.¹⁷⁰ In general, the situations of residents are not comparable with the situations of non residents.¹⁷¹ Differences often occur between residents and non residents regarding personal and family circumstances.¹⁷² However, such a distinction may not be used in order to treat non residents differently. Such measures are required to be justified on objective grounds and in accordance with the proportionality principle.¹⁷³

Once it has been established that two comparable situations and an obstacle exists, it must be considered whether the treatment nevertheless is allowed due to justification grounds.¹⁷⁴ In general, Article 36 of the TFEU and the *rule of reason* constitute the two possible ways to justify a prohibited measure.¹⁷⁵ As Article 36 of the TFEU does not accept justifications of economic nature, the CJEU also accept restrictions that are justified according to rule of reason, developed in the *Cassis de Dijon* case, if the

¹⁶⁴ Ibid, p. 12.

¹⁶⁵ Zester, Intertax Vol. 34 Issue 3 (2006), p.148.

¹⁶⁶ C-157/07 *Krankenheim*, para. 30; C- 415/93 *Bosman*, para. 96; C- 55/94 *Gebhard*, para. 37.

¹⁶⁷ C- 415/93 *Bosman*, paras 98 & 99.

¹⁶⁸ Hilling, Intertax Vol. 41 Issue 5 (2013), p. 296.

¹⁶⁹ Terra; Wattel, (2012), p. 55.

¹⁷⁰ Moëll, (2003), p. 142.

¹⁷¹ C- 279/93 *Schumacker*, para. 31.

¹⁷² C- 279/93 *Schumacker*, para. 32.

¹⁷³ Moëll, (2003), p. 142.

¹⁷⁴ Helminen, (2015),p. 41.

¹⁷⁵ Terra; Wattel, 2012, p. 58.

“tax treatment has an objective that is in accordance with TFEU and which is justified by an overriding reason in the public interest”¹⁷⁶.

Different justification grounds have been developed by the case law of the CJEU, as different Member States have claimed different justification grounds to be in accordance with the public interest. The accepted reasons for justification that have been developed are the need to ensure recovery of a tax debt, safeguarding effectiveness of fiscal supervision, anti avoidance purpose, safeguarding balanced allocation of taxing rights between Member States, the need to prevent a double use of losses, safeguarding fiscal cohesion of the national tax system and the territoriality principle.¹⁷⁷ Since the *Marks & Spencer* case, the CJEU assesses the justification grounds by considering the grounds together instead of separately.¹⁷⁸ In combination with the fact that the justification grounds solely have been developed by the case law of the CJEU, this new assessment ground may result in a decreased predictability.¹⁷⁹

In order for a restrictive measure to be justified according to the principle of rule of reason, it may “not go beyond what is necessary for that purpose.”¹⁸⁰ Thus, if the objective could be reached with a measure in a less restrictive manner than the tax provisions in question, they are not acceptable.¹⁸¹

¹⁷⁶ Ibid, p. 59. See also, inter alia, C- 35/98, *Verkooijen*, para. 43.

¹⁷⁷ Helminen, (2015), p. 42.

¹⁷⁸ C-446/03 *Marks & Spencer*, para. 52; Supra n. 163.

¹⁷⁹ Ståhl et. al, (2011), p.167.

¹⁸⁰ See, inter alia, C- 250/95 *Futura*, para 26; C- 324/00 *Lankhorst- Hohorst*, para. 33; C- 436/00, *X&Y*, para 49; C- 9/02 *De Lasteyrie du Saillant*, para 49; C- 446/03, *Marks & Spencer*, para. 35; C- 196/96 *Cadbury Schweppes*, para. 47.

¹⁸¹ Helminen, (2015), p. 7.

4 To what extent does EU law apply to the provisions included in a tax treaty?

This section deals with the question regarding the influence of EU law on provisions included in a tax treaty. A general, non exhaustive review will be provided in order to contribute to the understanding of why a potential principle of MFN treatment in EU law would have any impact on bilateral tax treaties.

Initially, it is worth mentioning that although direct taxation falls within the competence of the Member States, they must still comply with EU law.¹⁸² Furthermore, a Member State cannot rely on a tax treaty in order to circumvent the applicable EU law.¹⁸³ As the CJEU ruled in *Avoir Fiscal*, the right of establishment cannot be made subject to the contents of a tax treaty. The CJEU also emphasised that the right of establishment cannot be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding benefits in other Member States.¹⁸⁴ However, in case a domestic measure constitutes a breach to a fundamental freedom, the tax treaty may be considered in order to neutralise the impediment.¹⁸⁵ Thus, the fact that a provision is based on a tax treaty does not alter the fact that it must comply with the right of free movement. As the CJEU held in the *Gottardo* case, the principle of reciprocity of a bilateral international convention concluded between a Member State and a non member country may constitute an objective justification to refuse an extension of benefits to nationals of other Member States.¹⁸⁶ However, the justification was not applied in the case in question.¹⁸⁷

4.1 The allocation of taxing rights

The *Gilly* case is the first case in which the CJEU dealt with the compatibility of provisions in a tax treaty with the provisions of the fundamental freedoms.¹⁸⁸ A French and German national, Mrs Gilly, working in Germany, was liable to tax on her remuneration in both France and in Germany.¹⁸⁹ In order to eliminate double taxation, Mrs Gilly was

¹⁸² See, *inter alia*, C- 385/00 *de Groot*, para. 75; C- 279/93 *Schumacker*, para. 21, C-391/97 *Gschwind*, para. 20; Joined Cases C- 397/98 and C-410/98 *Metallgesellschaft*, para. 37.

¹⁸³ Cordewener & Reimer, *European Taxation* Vol. 46 No 7 (2006), p.295.

¹⁸⁴ C- 270/83 *Commission v France*, Para. 26

¹⁸⁵ See, *inter alia*, Opinion of AG Bot in C- 194/06 *Orange European Smallcap Fund*, finding 59; C- 170/05 *Denkavit International BV*, para. 45

¹⁸⁶ C- 55/00 *Gottardo*, para. 36.

¹⁸⁷ *Ibid*, para. 37.

¹⁸⁸ Hilling, (2005), p. 247.

¹⁸⁹ C- 336/96, *Gilly*, paras 3 & 6.

entitled to a tax credit to be set against the French tax charged on the taxable amount. Nevertheless, there was a risk that the tax credit to be set against the French tax was less than the tax actually paid in Germany because of the greater progressivity of the tax scale there. Therefore, French frontier workers taxed in both Germany and in France would, after the deduction of the tax credit, be taxed more heavily compared to persons receiving that income solely in France.¹⁹⁰ The CJEU concluded that in the absence of any unifying or harmonizing measures within the EU with regard to direct taxation, it falls within the competence of the Member States to define the criteria for allocating their powers of taxation as between themselves in order to eliminate double taxation.¹⁹¹ Thus, the criteria that Member States establish for allocating their powers of taxation as between themselves are not contrary to EU law, no matter if the criterion is based on nationality.¹⁹² The opinion of AG Colomer was that Member States that conclude tax treaties in order to prevent double taxation, agree on limiting their fiscal sovereignty.¹⁹³ Of significant importance is the conclusion that the criteria are neutral with regard to the free movement of workers, as they do not treat workers of other Member States less favourable than its own nationals being in the same situation.¹⁹⁴ Furthermore, Member States remain competent within the field of direct taxation and are at liberty to bilaterally determine to what extent they agree to limit their taxation rights.¹⁹⁵ What is notable in the case is that the CJEU referred to the OECD Model and its Commentaries by stating that it is not unreasonable for the Member States to base their agreements on international practice and the OECD Model.¹⁹⁶ Furthermore, the absence of analysis regarding the effect of the tax provisions on the fundamental freedoms perhaps indicates that the CJEU pays attention to the fact that the tax treaty in question was based on the OECD Model.¹⁹⁷

In the *De Groot* case, a Dutch resident had received income from three other Member States.¹⁹⁸ The result from a specific method used in order to determine allowances, in accordance with tax treaties or Dutch legislation, was that allowances were deducted from the tax payable in the Netherlands only in proportion to the income received by the taxpayer in the Netherlands.¹⁹⁹ As a consequence, De Groot derived a lesser advantage than if all of his income had been derived from the Netherlands.²⁰⁰ In the case in question, the CJEU emphasised that the situation was different from that of in the *Gilly* case. Unlike the situation in the *Gilly* case, the tax disadvantage that De Groot suffered did not result from the differences of the tax rates in the residence state and the state of employment. Unlike the situation in the

¹⁹⁰ Ibid, para 8-10.

¹⁹¹ Ibid, para. 30.

¹⁹² Van der Linde, EC Tax Review Vol. 13 Issue 1,(2004), p.14.

¹⁹³ Opinion of AG Colomer in C- 336/96 *Gilly*, finding 44.

¹⁹⁴ C- 336/96 *Gilly*, paras. 44-45

¹⁹⁵ Cordewener & Reimer, European Taxation Vol.46 No 7 (2006), p. 299 f.

¹⁹⁶ C- 336/96 *Gilly*, para. 31.

¹⁹⁷ Hilling, (2005), p. 284.

¹⁹⁸ C- 385/00 *de Groot*, para. 27.

¹⁹⁹ Ibid, para. 26.

²⁰⁰ Ibid, Para. 83.

Gilly case, De Groot was deprived part of his reductions in the state of residence because he exercised his right to free movement.²⁰¹ Since the specific method that was used in order to determine the allowances was not based on the OECD Model and was contrary to the provisions on the free movement without having any impact on the tax treaty network between other Member States, it could, according to Hilling, be argued that the CJEU would assess the tax provisions as unilateral tax provisions in line with the established reasoning in the case law of free movement.²⁰²

4.2 Extension of treaty benefits

The *Saint Gobain* case concerned a French company with a permanent establishment in Germany, which was refused treaty benefits granted by a tax treaty concluded between Germany and non Member States. The treaty benefits were restricted to German companies.²⁰³ The CJEU stressed that although Member States are competent to determine the connecting factors for purposes of allocating powers of taxation, they must nevertheless not disregard EU law.²⁰⁴ As a consequence, with regard to the national treatment principle, a Member State that has concluded a tax treaty with a non Member State must extend the benefits granted to resident companies to the permanent establishment.²⁰⁵ The CJEU stated that the balance and reciprocity of the tax treaties concluded by Germany with non Member States would not be called into question by a unilateral extension regarding the recipients of the tax benefits in Germany provided for by these treaties. The extension would not affect the rights on the non Member States and would not impose any new obligation on them.²⁰⁶ Furthermore, the different outcome in the *Saint Gobain* case compared to the *Gilly* case might have depended on the fact that an extension of the treaty benefits would not affect the functioning of the applicable tax treaties.²⁰⁷

The *Open Skies* cases concerned bilateral “open skies” agreements concluded between the EU member states and the US.²⁰⁸ The issue concerned discrimination of the freedom of establishment by the application of the agreement between the UK and the US since the agreement gave the US the right to refuse the granting of traffic rights of airlines established in the UK that were owned and controlled by nationals of other Member States. If, instead, air carriers were owned and controlled by UK nationals, they would be granted the traffic rights.²⁰⁹ The Commission brought an action claiming that the UK had infringed the EU law by concluding and applying the “open skies” agreements, which included a nationality

²⁰¹ Ibid, Para. 86-87.

²⁰² Hilling, (2005), p. 276 f.

²⁰³ C- 307/97 *Saint Gobain*, paras. 3-8.

²⁰⁴ Ibid, para. 57-58.

²⁰⁵ Ibid, para. 59.

²⁰⁶ Ibid, para. 60.

²⁰⁷ Hilling, (2005), p. 284.

²⁰⁸ C- 466/98 *Commission v United Kingdom*, para. 7.

²⁰⁹ Ibid, para. 10.

clause.²¹⁰ Although the *Open Skies* cases did not concern direct taxation, the decision is of significance regarding tax treaties. The nationality clause included in the “open skies” agreement and LOB clauses have in common that they establish a threshold regarding the application of international agreements since they will apply only to companies not substantially owned by foreign shareholders.²¹¹ Of significance in the case is that the source of discrimination derived from the provision in the bilateral tax treaty, which allowed the US to act in a certain way, and not from the possible conduct of the US.²¹² Hence, the UK failed to fulfil its obligations under EU law by concluding and applying the agreement.²¹³ The CJEU referred to the ruling in *Saint Gobain* and concluded that the fact that a provision is included in an international convention does not have any impact on the provisions on the freedom to move.²¹⁴

In the *Gottardo* case, the CJEU ruled that when a Member State concludes a bilateral convention on social security with a non member country, that Member State has to allow nationals of other Member States the same benefits as those which its own nationals are allowed unless it can demonstrate objective justification for refusing to do so.²¹⁵ The CJEU ruled that a commitment under international agreements between Member States or between a Member State and a non member country must comply with EU law.²¹⁶ It could be perceived that the CJEU did not consider the tax treaty constituting the issue, since the problem derived to the fact that the domestic legislation of a Member State did not allow nationals of another Member State, which have used their right to free movement, equal benefits. What is of relevance is the effect of the domestic legislation with regard to fundamental freedoms in cross border situations. Nevertheless, it should be pointed out that it was the combination of domestic legislation and the provisions of the tax treaties that created the unfavourable effects and, hence, infringed the principle of national treatment. The solution on such discrimination was that the Member States had to apply the domestic legislation unilaterally, as if non residents and nationals of other Member States had gained access to the tax treaty. However, the stance of Cordewener and Reimer is that such a solution does not change the fact that the discrimination derives from the combination of domestic law and the application of a tax treaty.²¹⁷

4.3 Conclusion

Furthermore, it can be concluded that the sole ground that a provision is based on a tax treaty does not in itself justify a breach of the freedom to

²¹⁰ Ibid, para. 15.

²¹¹ Pistone, EC Tax Review Vol.14 Issue 1 (2005),p.6.

²¹² Case C-466/98 *Commission v United Kingdom*, para. 51.

²¹³ Ibid, para. 52.

²¹⁴ C- 466/98 *Commission v United Kingdom*, para. 54. See also Hilling, 2005, p. 246.

²¹⁵ C- 55/00, *Gottardo*, para. 34.

²¹⁶ Ibid para. 33.

²¹⁷ Cordewener & Reimer, European Taxation Vol. 46 No 6 (2006), p.248.

move.²¹⁸ It can also be concluded that, in general, it is the interplay between tax treaties and domestic legislation that creates discrimination. Discrimination may also flow directly from the tax treaty alone with the result that the tax treaty is violating the fundamental freedoms.²¹⁹ Regarding the compatibility of treaty provisions with EU law, two important conclusions can be drawn after the decision in the *Gilly* case. Member States remain competent in relation to the field of direct taxation to unilaterally determine the criteria on which the tax jurisdiction will be based. In the same way, they remain competent to bilaterally set out criteria in order to determine to what extent they agree on limiting their taxation rights in relation to other states.²²⁰ In the *Gilly* case, the CJEU did not even assess whether there were comparable situations. Likely, one matter of importance seems to be whether a tax treaty provision is based on the OECD Model. The OECD Model has played a significant role in harmonizing the tax treaty system, why it would lead to consequences if a tax provision based on the OECD Model would not be accepted.²²¹ As Hilling concludes, if, on the contrary, a tax treaty provision is not based on the OECD Model, it could be assumed that the tax treaty provision at issue will be assessed in a similar way as to the assessment of a domestic provision.²²² However, as the EU law does not determine the connecting factors for the purposes of allocating taxation rights, the Member States remain competent to set the criteria.²²³ The Member States must nevertheless still comply with the principle of national treatment and the fundamental freedoms when allocating their powers of taxation.²²⁴ As it can be drawn as a conclusion that the freedom of Member States to conclude tax treaties may not be contrary to the fundamental freedoms, it is of essential importance to analyse to what extent a principle of MFN treatment may apply to tax treaties. In order to analyse whether the EU law imposes an MFN treatment on Member States, the question that needs to be analysed is whether tax treaties can create horizontal discrimination. Chapter 5 deals with the issue of horizontal discrimination.

²¹⁸ Hilling, (2005), p. 279.

²¹⁹ Cordewener & Reimer, European Taxation Vol. 46 No 6 (2006), p.249.

²²⁰ Ibid, p. 299.

²²¹ Hilling, (2005), p. 284.

²²² Ibid, p. 286.

²²³ Weber & Spierts, European Taxation Vol. 44 No. 2 (2004), p. 68

²²⁴ C- 385/00 *De Groot*, para. 94; C- 307/97 *Saint Gobain*, para. 58.

5 Horizontal discrimination

The fundamental freedoms provided by the TFEU may be referred to as principles prohibiting non discrimination.²²⁵ The principle of MFN treatment derives from the concept of horizontal discrimination. It may be referred to as a tool against discrimination, since the decisive factor is whether the unequal treatment of two cross border situations by a certain Member State is allowed, may it be the host state or the residence state of the taxpayer.²²⁶ As has already been clarified, discrimination may occur by the application of different rules to comparable situations or the application of the same rules to different situations and is acceptable only in case it can be justified.²²⁷

According to, *inter alia*, the opinion of Gerard Meussen, horizontal discrimination can be derived from general prohibition of discrimination in Article 18 of the TFEU.²²⁸ However, whether the fundamental freedoms protect discrimination between different Member States and not only vertical discrimination of residents compared to non residents have been disputed in case law and in doctrine. As will be discussed in adjunction with the *D* case, the CJEU has allowed a difference in treatment between two foreigners if it is the consequence of the applicable tax treaty. What is questionable is why a difference in treatment should be allowed solely because of the application of a tax treaty since EU law has direct effect and priority. Why would discrimination as such then be accepted?²²⁹

5.1 The development of MFN clauses in WTO law and International tax law

The principle of MFN treatment can be traced back to the Middle Ages when the merchants aimed at securing a monopoly as the market was foreign and difficult. The merchants failed in doing so because of the development of the commerce. Instead, they tried to gain equal opportunities as their competitors. However, the first MFN clause in bilateral treaties appeared in the fifteenth century in the treaty concluded between Henry V of England and the Duke of Burgundy and Count of Flanders of 17 August 1417. However, the reciprocal benefits between the contracting states were restricted to certain states. The restriction was abolished by the end of the fifteenth century when the privileges were extended to any foreign state. The first full fledged MFN clause was contained in the commercial treaty between England and France in the

²²⁵ Lehner, (1997), p. 17.

²²⁶ Cordewener & Reimer, European Taxation Vol.46 No 7 (2006), p. 300 f.

²²⁷ C- 279/93 *Schumacker*, para 30; Lehner, (1997), p. 17. See section 3.2.

²²⁸ Meussen, European Taxation Vol. 54 No. 7 (2014), p.324.

²²⁹ Van Thiel, Intertax Vol. 33 Issue 10 (2005), p. 455 & De Groot, Intertax Vol. 42 Issue 6/7 (2014), p. 405f.

eighteenth century.²³⁰ Furthermore, the principle of MFN treatment has been the core of the trade policy for centuries. It has been frequently included in Friendship, Commerce and Navigation treaties.²³¹

Today, the principle of MFN treatment exists in several bilateral and multilateral international treaties.²³² Since many tax treaties are based on the OECD Model, which does not contain an MFN principle, it can be concluded that the MFN principle is not, as a general rule, included in international tax law. While international tax law mainly consists of bilateral tax treaties, international trade law consists of multinational treaties. GATT, GATS and NAFTA are important examples of multilateral trade agreements. They do all include a general MFN clause, which obliges the signatories to afford MFN treatment to the citizens of the other signatories. The MFN clauses in multilateral trade agreements are unrestricted and therefore cover all areas that may impose obstacles to international trade. Furthermore, taxation may also be covered by these MFN clauses. However, doubts appear in relation to direct taxation as some trade agreements only apply to taxes on certain goods.²³³

The principle of MFN treatment, which was introduced in GATT 1947, constitutes a “cornerstone” of the World Trade Organisation (WTO) as well as the “defining principle” of GATT, which has been a part of the WTO since 1995.²³⁴ The purpose of GATT is the promotion of free trade between the Member States.²³⁵ A legal basis for the MFN treatment in the context of public international law regarding goods can be found under Article 1 of the GATT, which covers customs and excise duties.²³⁶ According to Article 1 of the 1994 GATT, “[...] any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties”. Since the MFN principle applies to all types of rules and is not limited to customs duties, it also applies to indirect and direct taxation in case they distinguish products based on their country of origin.²³⁷

Since customs duties on cross border services are not possible, the question is whether special provisions regarding direct or indirect taxation are adopted. The principle of MFN treatment regarding cross border services is contained in Article II of the GATS. Article XVII of the GATS covers national treatment. However, unlike indirect taxation, direct taxation is subject to an exception of the MFN treatment according to Article XIV. Thus, if the difference in treatment in relation to direct taxation results from

²³⁰ United Nations, Yearbook of the International Law Commission, 1969, p. 159 f.

²³¹ OECD (2004), OECD Working Papers on International Investment, 2004/02, p. 3.

²³² Cordewener & Reimer, European Taxation Vol. 46 No 6 (2006), p. 242.

²³³ Dürrschmidt, Bulletin for International Taxation Vol. 60 No. 5 (2006), p. 202.

²³⁴ UNCTAD Series 2010. p. 1; World Trade Organization, *The 128 countries that signed GATT by 1994*.

²³⁵ Schön, Bulletin for International Taxation Vol. 58 No. 7 (2004),p. 283.

²³⁶ Article I, General Agreements on Tariffs and Trade 1994.

²³⁷ Schön, Bulletin for International Taxation Vol. 58 No. 7 (2004),p.287.

a provision in a tax treaty, it is not subject to MFN treatment.²³⁸ Furthermore, while GATS and NAFTA expressly exclude the MFN principle from tax treaties, GATT does not. However, the GATT should not affect the conclusion of tax treaties since multilateral trade agreements do not apply to tax treaty benefits.²³⁹

WTO law partly serves a different purpose compared to EU law. Thus, while the integration in an internal market and the free movement of persons, goods, services and capital is an essential aim of the EU, the WTO aims to provide an undistorted import and export between different markets. Additionally, it focuses only on goods and services. The fundamental freedoms in the TFEU does not provide for an explicit MFN treatment, why the question remains as to what extent Member States of the EU may enter into tax treaties with each other, or whether they are required to extend a benefit under a tax treaty to other foreign taxpayers.²⁴⁰

5.2 Does the prohibition of discrimination within the EU include the principle of MFN treatment?

As a result of negotiations between contracting states and in light of political and economic conditions, benefits that derive from tax treaties may differ between them. Hence, the question is to what extent a state is required to extend a treaty benefit granted under a tax treaty between two contracting states to a taxpayer resident or national of a third state claiming that benefit.²⁴¹ Equal treatment, in an EU context, is a principle of law which has been implemented in the directly applicable provisions and which prohibits discrimination.²⁴² The right to an MFN treatment constitutes a prohibition against horizontal discrimination and intends to ensure that a resident of another state is granted the same benefit as a resident of the most favoured nation.²⁴³ The existence of the MFN principle within the field of direct taxation is still disputed because of two reasons. The prohibition of any discrimination according to Article 18 of the TFEU may be a reason for its existence but, on the other hand, it may undermine the balance of reciprocity that tax treaties are based on.²⁴⁴ Since ‘any’ discrimination is prohibited under Article 18 of the TFEU, it could be argued that horizontal discrimination also is covered by the scope of application. The only difference between horizontal discrimination and traditional discrimination between a domestic taxpayer and a foreign taxpayer is the comparative element.²⁴⁵ Starting with the ruling of the CJEU in the *Bachmann* case,

²³⁸ Ibid, p. 284.

²³⁹ Dürschmidt, Bulletin for International Taxation Vol. 60 No. 5 (2006), p. 203.

²⁴⁰ Schön, Bulletin for International Taxation Vol. 58 No. 7 (2004), p.284.

²⁴¹ Dürschmidt, Bulletin for International Taxation Vol. 60 No. 5 (2006), p. 202.

²⁴² Van Thiel, European taxation Vol. 47 No. 7 (2007), p.314.

²⁴³ Cordewener & Reimer, European Taxation Vol. 46 No 6 (2006), p. 242.

²⁴⁴ Zester, Intertax Vol. 34 Issue 3 (2006), p.143.

²⁴⁵ Ibid p. 144.

Kemmeren considered that EU law does not contain an MFN treatment unless explicitly laid down in a tax treaty or by the adoption of the Council of coordinating or harmonizing measures.²⁴⁶ However, Cordewener and Reimer did not share this view as they considered that the CJEU did not sufficiently observe the bilateral agreements that were concluded by the Member States in question. A brief consideration of the effect of a tax treaty does not answer the question regarding the principle of MFN treatment.²⁴⁷ According to Hinnekens, the MFN treatment goes beyond the effect of non-discrimination and would limit the freedom of Member States to conclude contracts.²⁴⁸ Article 4(3) of the TEU lays down a loyalty clause, which obliges the Member States to cooperate with each other. Furthermore, it could be argued that the refusal of the MFN treatment would constitute an infringement against the obligation of loyal cooperation of the Member States.²⁴⁹ However, the provision presupposes specific provisions laid down in EU law and only forces the Member States to perform in accordance with these obligations. As a consequence, some authors consider that Article 4(3) TEU does not constitute a legal basis for an MFN treatment.²⁵⁰

Proponents of the MFN treatment find their support through a teleological interpretation of the fundamental freedoms and argue that it would be in line with the basic principle to create an internal market without any frontiers, which is implemented in Article 26 of the TFEU.²⁵¹ The free movement of workers prohibit “any discrimination” and the free movement of capital prohibit “restriction”. The freedom of establishment and the freedom to provide services only require national treatment and, consequently, does not provide for an MFN treatment. However, it could be argued that, in order to satisfy the object of the creation of an internal market within the EU, a teleological interpretation of the fundamental freedoms contains a principle of MFN treatment.²⁵² That object could also be fulfilled by combining the application of the fundamental freedoms with the general non discrimination provision in Article 18 of the TFEU.²⁵³ Another important matter is that Member States may not conclude tax treaties with third countries that may infringe substantial interests of residents or nationals in other Member States.²⁵⁴ The essential issue of the MFN treatment is whether two non-residents from different Member States are in comparable situations.²⁵⁵

Hence, since the principle of MFN treatment constitutes a method to prevent restrictive measures based on the tax policy of a state, it does not take any account to the “give and take” resulting from treaty negotiations. This could

²⁴⁶ C- 204/90 *Bachmann*, para.26; Kemmeren, (1997) 6 EC Tax Review, Issue 3, p. 152.

²⁴⁷ Cordewener; Reimer, *European Taxation* 2006 (Volume 46) No 6p, p. 244.

²⁴⁸ Hinnekens, *EC Tax Review* Vol. 3 Issue 4 (1994),p.152 f.f.

²⁴⁹ Hinnekens, *EC Tax Review* Vol. 4 Issue 4 (1995) p. 215.

²⁵⁰ Cordewener & Reimer, *European Taxation* Vol. 46 No 6 (2006), p. 244.

²⁵¹ Dürschmidt, *Bulletin for International Taxation* Vol. 60 No. 5 (2006), p. 208.

²⁵² *Ibid*, p. 209.

²⁵³ De Groot, *Intertax* Vol. 42 Issue 6/7 (2014), p. 406.

²⁵⁴ Van Thiel, *European Taxation* Vol. 47 No. 7 (2007), p. 455 & De Groot, *Intertax* Vol. 42 Issue 6/7(2014), p. 405 f.

²⁵⁵ Dürschmidt, *Bulletin for International Taxation* Vol. 60 No. 5 (2006), p. 208.

be compared to the LOB clause, which instead intends to counteract treaty shopping and, thus, aims at strengthening the taxation right of the state.²⁵⁶ By treating all nationals and residents of the EU from all Member States equally, which will be achieved by extending benefits to all taxpayers within the EU, capital import neutrality will be generated.²⁵⁷

To conclude, the authors that advocate an MFN treatment base their arguments on a teleological method of interpretation. The opponents, on the other hand, argue that a principle of MFN treatment is not explicitly laid down in provisions of the fundamental freedoms. Thus, it may be questioned whether they should be interpreted that broadly.²⁵⁸ The opponents seem to advocate a systematic method of interpretation with the result that the wordings of the fundamental freedoms do not cover a prohibition of horizontal discrimination. As it remains unclear whether the provisions prohibiting discrimination within the EU contains a principle of MFN treatment, the case law dealing with the topic is essential to analyse in order to provide a somewhat clearer answer.

5.3 The application of domestic measures in cross border situations

Before analysing the standpoint of the CJEU when difference in treatment between two cross border situations is the result of the application of a tax treaty provision, it will first be analysed whether a Member State must apply an MFN treatment when a unilateral measure gives rise to unequal treatment.

One case to deal with the issue in question is *Cadbury Schweppes*.²⁵⁹ *Cadbury Schweppes* concerned CFC legislation in the UK, according to which the profits of a foreign subsidiary in which the resident parent company held more than 50 per cent was taxed in the hands of the parent company. In order to evade double taxation, a tax credit was granted for the tax paid in the state in which the subsidiary was established.²⁶⁰ If the tax paid in the state where the subsidiary was established was less than 75 per cent of the tax paid in the state of residence of the parent company, the subsidiary was subject to “a lower level of taxation”, with the result that the CFC legislation applied.²⁶¹ The question referred to the CJEU was whether the cross border situation in question should be compared to a domestic situation or to another cross border situation.²⁶²

The comparison the CJEU was making was between a parent company with a subsidiary in a state in which it is subject to a lower level of taxation and

²⁵⁶ Zester, *Intertax* Vol. 34 Issue 3 (2006), p.143.

²⁵⁷ Rädler, *EC Tax Review* Vol. 4 Issue 2 (1995), p. 67.

²⁵⁸ Dürschmidt, *Bulletin for International Taxation* Vol. 60 No. 5 (2006), p. 209.

²⁵⁹ C- 196/04 *Cadbury Schweppes*.

²⁶⁰ *Ibid*, para. 6.

²⁶¹ *Ibid*, para. 7.

²⁶² *Ibid*, para. 26.

where, on the other hand, the parent company had incorporated a subsidiary in the UK or in a state in which it was not subject to a lower level of taxation. In the latter case, the CFC legislation would not apply.²⁶³ Thus, the difference in treatment had created a tax disadvantage.²⁶⁴ Furthermore, two elements were being compared and as De Groot reflects, two cross border situations were considered to be in comparable situations although the CJEU did not expressly mention it.²⁶⁵ Additionally, Advocate General Leger took the view that the only question to be considered in order to determine whether a different treatment of two situations is discriminatory is whether the situations are comparable. Furthermore, two cross border situations should be compared since there was an unequal treatment between the parent company with a subsidiary in a state with lower level of taxation and a parent company in a state a less favourable tax regime.²⁶⁶ Thus, according to the CJEU, Member States have to treat two non residents on an equal manner with regard to a domestic measure such as the CFC legislation in question. The CJEU also concluded that, no matter of the tax motives behind the transaction, the legislation in question would only be justified in case it would target wholly artificial arrangements.²⁶⁷ Another conclusion that can be drawn from the case is therefore that the CJEU has accepted structures that are driven by tax motives.

In the *Columbus Container Services* case, the shares of the limited partnership Columbus, established in Belgium, were held in Germany.²⁶⁸ Columbus was under German law considered as a partnership.²⁶⁹ Thus, as partnerships are considered to be transparent, profits were taxed in the hands of the partners resident in Germany.²⁷⁰ If the income was taxed abroad at a rate of at least 30 per cent, the income was exempt in Germany.²⁷¹ If, on the other hand, the income was taxed abroad at a rate of less than 30 per cent, the income was instead subject to a tax credit in Germany.²⁷²

When considering the question whether the German legislation constituted discrimination of the freedom of establishment, the CJEU referred to the *Kerckhaert and Morres* case²⁷³, according to which no distinction was made between taxation of income derived from the profits of partnerships established in Germany, and taxation of income derived from the profits of partnerships established in another Member State subject to a tax rate of less than 30 per cent, since the same tax rate was applied in Germany in both cases by applying the credit method.²⁷⁴ Since no tax disadvantage occurred

²⁶³ Ibid, para. 44.

²⁶⁴ Ibid, para. 45.

²⁶⁵ De Groot, *Intertax* Vol. 42 Issue 6/7 (2014), p. 407.

²⁶⁶ Opinion of AG Leger in case C- 196/04 *Cadbury Schweppes*, findings 77-78.

²⁶⁷ C- 196/04, *Cadbury Schweppes*, para. 75.

²⁶⁸ C- 298/05 *Columbus Container Services*, paras 13 & 14.

²⁶⁹ Ibid, para. 18.

²⁷⁰ Ibid, para. 4.

²⁷¹ Ibid, para. 8.

²⁷² Ibid, paras. 9 & 11.

²⁷³ C- 513/04 *Kerckhaert and Morres*, para 17.

²⁷⁴ C- 298/05, *Columbus Container Services*, para 39.

compared to partnerships established in Germany, no discrimination was the result from the different treatment.²⁷⁵ The CJEU highlighted that the consequences from the tax system in question was the result of the parallel exercise of the fiscal sovereignty of two Member States.²⁷⁶

In the *Columbus Container Services* case, the CJEU took a different approach compared to *Cadbury Schweppes* by underlining the tax competence of the Member States. Member States enjoy certain autonomy. As a consequence of the lack of harmonization within the EU, the freedom of companies and partnerships to choose in what Member State to establish does not mean that the Member State in question is required to adapt its tax system in order to ensure that the company or partnership established in a Member State is taxed in the same way as a company or partnership established in another Member State.²⁷⁷ Consequently, the CJEU did not consider the difference in treatment of two cross border situations sufficient reason for the measure to constitute discrimination.²⁷⁸ The provisions that were being scrutinized concerned rules on avoidance of double taxation. When comparing with other case law dealing with rules on avoidance of double taxation, the decision of the CJEU could be perceived as remarkable. For instance, in the *Test Claimants in the FII Group Litigation* case, the CJEU concluded that when establishing a mechanism for prevention of double taxation, the Member States must comply with the EU law.²⁷⁹ On the other hand, with regard to the situation in the *Columbus Container Services* case, account may be taken to the fact that the total tax burden in Germany always will be 30 per cent, why the German law would not constitute an infringement in the internal market. If that is the reason for the ruling of the CJEU, the ruling at issue may not have accepted a general acceptance of different treatment of cross border situations.²⁸⁰

5.4 The MFN treatment with regard to tax treaty provisions

In relation to horizontal discrimination of treaty benefits, it was in the *D* case and the *Test Claimants in Class IV of the ACT Group Litigation* case analysed whether an obstacle of the fundamental freedoms was present because of the difference in treatment of residents of different Member States as a result of the applicable tax treaty.²⁸¹ No horizontal discrimination was present since the CJEU reasoned that residents of different Member States, who are covered by different tax treaties, are not in comparable situations, as the treaty benefit constituted an integral part of the tax

²⁷⁵ Ibid, para 40.

²⁷⁶ Ibid, para 43.

²⁷⁷ Ibid, para 51.

²⁷⁸ De Groot, Intertax Vol. 42 Issue 6/7 (2014), p. 409.

²⁷⁹ C-446/04, *Test Claimants in the FII Group Litigation*, para. 45.

²⁸⁰ De Groot, Intertax Vol. 42 Issue 6/7 (2014), p. 409.

²⁸¹ C- 376/03 *D*, paras. 53-63; C 374/04 *Test Claimants in Class IV of the ACT Group Litigation*, paras. 82 and 83.

treaty.²⁸² In cases relating to, instead, national measures in combination with the applicable tax treaty, the CJEU held in the *Orange European Smallcap Fund* case that the refusal of the granting of a benefit with regard to dividends deriving from certain Member States constitutes an impediment of the fundamental freedoms.²⁸³ Furthermore, a decisive element for horizontal discrimination to occur is that two cross border situations are objectively comparable, which will be further analysed in connection with the case law provided in this section.

5.4.1 The *D* case; is reciprocity a sufficient reason to deny application of an MFN treatment?

In the *D* case, the CJEU contributed a ruling on whether differences in treatment between non resident taxpayers resulting from the application of a tax treaty constitute a restriction on the right to free movement.²⁸⁴ The case concerned the Dutch wealth tax legislation, according to which residents in the Netherlands were granted an allowance regarding their assets worldwide. Non resident taxpayers were not granted such tax allowance apart from when at least 90 per cent of the wealth of non resident taxpayers was situated in the Netherlands.²⁸⁵ Belgian taxpayers were also entitled to the allowances according to a non discrimination provision under Article 25(3) of the tax treaty concluded between Belgium and the Netherlands.²⁸⁶ D was a resident in Germany and held 10 per cent of his wealth situated in the Netherlands where he was liable to wealth tax as a non resident.²⁸⁷ The CJEU ruled on the difference between a resident and a non resident taxpayer, as well as on the difference made in the tax treaty between Belgium and the Netherlands between a resident in Belgium and a foreign resident not covered by the tax treaty.²⁸⁸ As concluded in the *Schumacker* case, the situations of a resident and a non resident are not, as a rule, comparable.²⁸⁹ Furthermore, it is up to the state of residence to take into account family and personal circumstances, unless the income of the taxpayer is earned almost entirely in state of source and the income earned in the state of residence is negligible, so that this state is not in the position to grant the taxpayer benefits resulting from the taking into account of his family and personal circumstances.²⁹⁰ As resident D only held a minor part of his wealth in the Netherlands, he was not considered to be in a situation

²⁸² C- 376/03 *D*, para. 62; C- 374/04, *Test Claimants in Class IV of the ACT Group Litigation*, para. 88; See also CFE ECJ Task Force, *European Taxation* Vol. 56 No. 2/3 (2016), p. 96.

²⁸³ C- 194/06, *Orange European Smallcap Fund*, para. 56.

²⁸⁴ Weber, *Intertax* Vol. 33 Issue 10 (2005), p. 429.

²⁸⁵ C- 376/03 *D*, paras 7 & 9.

²⁸⁶ *Ibid.* para. 13.

²⁸⁷ *Ibid.* para 15.

²⁸⁸ C- 376/03 *D*, para 19.

²⁸⁹ C-279/93 *Schumacker*, para. 31; C- 376/03 *D*, para. 26.

²⁹⁰ C-279/93 *Schumacker*, Para. 36

comparable to that of a resident. Thus, D was not discriminated against compared to a domestic taxpayer.²⁹¹

The CJEU also considered whether the different treatment of a Belgian taxpayer compared to a German taxpayer, being in the same situation, constituted prohibited discrimination with regard to the free movement of capital.²⁹² As pointed out in the *Gilly* case, no unifying or harmonising measures for the elimination of double taxation has been adopted in the EU and the Member States are at liberty to determine the connecting purposes of allocation of powers of taxation. Therefore, a difference in treatment of nationals of two contracting states does not constitute discrimination as a result from the allocation of powers of taxation.²⁹³ On the other hand, the case in question concerned the comparison between two non residents being party to different tax treaties.²⁹⁴ Hence, there is a similarity to the *Columbus Container Services* case, since the comparison in both cases relates to whether two foreign taxpayers are being treated differently. De Groot believes that the CJEU recognizes the difference in treatment between two non residents who are in objective comparable situations to constitute a restriction in the freedom to move.²⁹⁵ In the case in question, however, the two non residents were not deemed to be in a comparable situation because the reciprocal rights and obligations that apply to persons covered under the tax treaty is an inherent consequence of bilateral tax treaties.²⁹⁶ General Advocate Ruiz- Jarabo Colomer found the *D* case bearing similarities with the *Saint Gobain* case.²⁹⁷ However, remarkable differences could be found. In *Saint Gobain*, a non resident taxpayer requested to be treated as a domestic taxpayer regarding the application of a tax treaty while the *D* case concerned the comparison between two foreign taxpayers.²⁹⁸

Hence, the difference in treatment was allowed since the tax treaty provides for reciprocal rights and obligations and can only be applied to residents of the parties of the tax treaty. Additionally, the tax allowance constitutes an inseparable and integral part of the tax treaty and contributes to its overall balance. It could be questioned how this ruling is in line with the object of the internal market without frontiers and why the CJEU accepts a difference in treatment of two identical capitals deriving from two different Member States on the sole ground that it is based on a tax treaty.²⁹⁹ In general, the CJEU has previously not allowed that equal treatment depends on reciprocity.³⁰⁰ Noteworthy in the *D* case is that granting of the tax allowance is based on a non discrimination provision and not on a provision that

²⁹¹ C- 376/03 *D*, paras 41-43.

²⁹² *Ibid*, paras 44-46.

²⁹³ C- 376/03 *D*, para 52; C- 336/96, *Gilly*, para 30.

²⁹⁴ C- 376/03 *D*, para 53.

²⁹⁵ De Groot, *Intertax* Vol. 42 Issue 6/7 (2014), p. 409.

²⁹⁶ C- 376/03 *D*, para 61.

²⁹⁷ Opinion by AG Ruiz- Jarabo Colomer in C- 376/03 *D*, finding 88.

²⁹⁸ De Groot, *Intertax* Vol. 42 Issue 6/7 (2014), p. 410.

²⁹⁹ Van Thiel, *Intertax* Vol. 33 Issue 10 (2005), p.455.

³⁰⁰ Weber & Spierts, *European Taxation* Vol. 44 No. 2 (2004), p. 68. See also, *inter alia*, C- 270/83 *Commission v France*, para. 26.

allocates taxation rights in order to avoid double taxation.³⁰¹ Hence, the concession constitutes an allocation of a benefit, which, according to the European Commission, is not in compliance with the principle of equal treatment as it does not solely constitute a mere allocation of taxing rights.³⁰² To sum up, since the difference in treatment is included in the tax treaty, the CJEU accepts it. That is remarkable since the granting of the tax allowance has nothing to do with the avoidance of double taxation.³⁰³ On the other hand, if the CJEU had ruled that a principle of MFN treatment exists, that would lead to a harmonization of the tax treaties with the result that the revenue of the Member States would have been affected.³⁰⁴

5.4.2 The *Orange European Smallcap Fund* case; the application of domestic rules in combination with a tax treaty

The *Orange European Smallcap Fund* (“OESF”) case concerned the legislation in the Netherlands on the refund of withholding tax on dividends for fiscal investment enterprises. The profits of a fiscal investment enterprise was taxed at a zero rate, why it was impossible to credit Dutch or foreign withholding tax under a tax treaty.³⁰⁵ Where such enterprise receives dividends distributed by a company established in the Netherlands, Dutch withholding tax was refunded.³⁰⁶ A fiscal investment enterprise was, additionally, entitled a refund of foreign withholding tax, but only to the degree it had Dutch shareholders. Onwards, it could not exceed the amount of tax that would be deductible under a tax treaty or the tax regulations of the Kingdom in the event of direct investment.³⁰⁷ The question was whether the Dutch legislation constituted a restriction on the free movement of capital.³⁰⁸ The rules intended to ensure that the tax burden would be the same as that on direct investments.³⁰⁹ Furthermore, if no credit of withholding tax was entitled under a tax treaty in case of direct investment, no refund of withholding tax levied was allowed.³¹⁰ Hence, a distinction was made based on the Member State from which the dividends were derived.³¹¹ Regarding the distinction, the CJEU paid attention to the fact that no tax was levied on neither domestic nor foreign dividends.³¹² The CJEU reiterated that a Member State is not required to grant a concession in order to offset a disadvantage that results of double taxation but in case it does, it

³⁰¹ Weber; Intertax Vol. 33 Issue 10 (2005), p. 434.

³⁰² Weber & Spierts, European Taxation Vol. 44 No. 2 (2004), p. 68 & Commission of the European Communities, COM(2001) 582 final, 2001, p. 316.

³⁰³ Weber; Intertax Vol. 33 Issue 10 (2005), p. 440.

³⁰⁴ Dürschmidt, Bulletin for International Taxation Vol. 60 No. 5 (2006), p. 207.

³⁰⁵ C- 194/06, *Orange European Smallcap Fund*, paras 3-4 & 7.

³⁰⁶ Ibid, paras 5 & 6.

³⁰⁷ Ibid, paras 9-11.

³⁰⁸ Ibid, Para 21.

³⁰⁹ Ibid, Para 8.

³¹⁰ Ibid, Para 22.

³¹¹ De Groot, Intertax Vol. 42 Issue 6/7 (2014), p.411.

³¹² C- 194/06, *Orange European Smallcap Fund*, paras 35 & 36.

must still comply with EU law.³¹³ In accordance with the opinion of the Advocate General Bot, the concession did not result from the automatic application of the bilateral tax treaty, but from the unilateral decision of the Netherlands to extend a benefit resulting from a tax treaty.³¹⁴ The Dutch legislation made investments in certain Member States less attractive than investing in Member States in which taxation at source enables the granting of a concession.³¹⁵ In accordance with the view of de Groot, that appears to be a statement that means that a distinction between two cross border situations constitutes a restriction on the freedom of movement.³¹⁶

The CJEU continued to examine whether the two cross border situations were objectively comparable, which the CJEU did not consider to be the case. The Dutch legislation intended to treat investments through a fiscal investment enterprise equal to direct investments in order to prevent that investments through a fiscal investment enterprise was regarded as being a less attractive option. Furthermore, if a shareholder invests through a fiscal investment enterprise and receives dividends from a Member State with which the Netherlands has concluded a tax treaty, there is a risk of being less advantageous to a shareholder than investing directly. Adversely, there is no such risk to be treated less advantageous when investing through a fiscal investment enterprise in a Member State with which the Netherlands has not concluded a tax treaty, as the shareholder would not have been entitled to the benefit if investing directly in such Member State. Consequently, the CJEU concluded that the situation where the Netherlands had not concluded a tax treaty with the Member State from which the dividends derived was not objectively comparable with the situation in which the Netherlands had concluded such a tax treaty.³¹⁷ The *OESF* case differs from the *D* case since the two cross border situations in that case were not comparable as a result of the combination of national rules with a tax treaty.³¹⁸

The similarity between *OESF* and *Columbus Container Services* is that both cases dealt with the avoidance of juridical double taxation. Regarding that matter, however, the CJEU came to different conclusions in the two cases. In *Columbus Container Services*, the CJEU concluded that the absence of harmonizing measures on the avoidance of double taxation means that a Member State can tax the income from a company established in one Member State differently to the income from a company established in another Member State.³¹⁹ In contrast, in *OESF*, the CJEU concluded that, if measures on the avoidance of double taxation are present, they must be in accordance with EU law.³²⁰ A reason to the different outcomes may be that

³¹³ Ibid, para. 47.

³¹⁴ C- 194/06, *Orange European Smallcap Fund*, para. 54; Opinion of AG Bot in C-194/06, finding 7.

³¹⁵ Ibid, para. 56.

³¹⁶ De Groot, *Intertax* Vol. 42 Issue 6/7 (2014), p. 411.

³¹⁷ C- 194/06, *Orange European Smallcup Fund*, Para. 59- 65.

³¹⁸ De Groot, *Intertax* Vol. 42 Issue 6/7 (2014), p. 411.

³¹⁹ C- 298/05, *Columbus Container Services*, para 51

³²⁰ C- 194/06, *Orange European Smallcap Fund*, para. 47.

in the *Columbus Container Services* case, the German legislation did not cause a fragmentation of the internal market.³²¹

5.4.3 The *ACT Group Litigation* case and the interplay between the MFN treatment and the LOB clause

The *Test Claimants in Class IV of the ACT Group Litigation* case concerned the advance corporation tax (ACT), which a company resident in the UK that paid dividends to its shareholders was liable to pay. The system constituted an advance payment of the company making the distribution and a tax credit entitled to the shareholders receiving a dividend.³²² The issue of the case was whether the UK rule in question, which only grants tax credit to resident shareholders or non resident shareholders in states with which the UK has concluded a tax treaty providing for a tax credit, are contrary to the fundamental freedoms.³²³ Onwards, the tax treaty concluded between the UK and the Netherlands contained an LOB clause, according to which no tax credit was entitled under the tax treaty if the non resident shareholder was owned by a company not entitled to a tax credit.³²⁴

Regarding the comparability, the CJEU ruled that resident and non resident shareholders are, in principle, not comparable, unless income tax is imposed on non residents.³²⁵ However, the claimants objected to the difference in treatment imposed on non resident companies since tax treaties concluded between the UK and certain Member States provided for the tax credits while tax treaties concluded with other Member States did not. The CJEU then considered whether these non resident companies were in objectively comparable situations in order to determine whether the difference in treatment was discriminatory.³²⁶ It referred to the *D* case and held that the scope of tax treaties is limited to the persons referred to in it.³²⁷ Subsequently, the CJEU pointed out, as it did in the *D* case, that the granting of a tax credit could not be regarded as a separable benefit but as an integral part of the tax treaties since it was directly linked to the right of the UK to tax the companies of the dividends.³²⁸ Hence, the UK was not obliged to extend the treaty benefits to residents of a state not party to the tax treaty.³²⁹ By making a horizontal comparison the CJEU came to the conclusions based on the fact that in light of a tax treaty, from the perspective of the UK, a resident of the other contracting state cannot be compared to a resident of non contracting state.³³⁰ In general, regarding dividend cases, the CJEU has

³²¹ De Groot, *Intertax* Vol. 42 Issue 6/7 (2014), p. 412.

³²² C- 374/04 *Test Claimants in Class IV of the Act Group Litigation*, para. 5.

³²³ *Ibid*, para. 30.

³²⁴ *Ibid*, para. 20.

³²⁵ *Ibid*, para. 68.

³²⁶ *Ibid*, paras 82 & 83.

³²⁷ *Ibid*, para. 84.

³²⁸ *Ibid*, paras 87 & 88.

³²⁹ Debelva et. al., *EC Tax Review* Vol. 24 Issue 3 (2015), p. 135

³³⁰ *Ibid* p. 136.

instead ruled on vertical comparability between a resident and a non resident.³³¹

The terms under which a tax treaty provides for a tax credit to non resident companies vary depending on the characteristics of the tax jurisdiction, when the tax treaty was negotiated and to the extent that the Member States made an agreement with regard to the issues.³³² The opinion of Advocate General Geelhoed was that it is not possible to compare the situations of non residents covered by a tax treaty with non resident not covered by that tax treaty, since each tax treaty creates a certain balance between the tax jurisdictions in question and that they therefore are in different positions.³³³ The same reasoning applied regarding the LOB clause. Finally, the reciprocal rights and obligations apply only to persons resident in one of the contracting states and constitute an inherent consequence of bilateral tax treaties.³³⁴

The referring court explicitly raised the question of whether the LOB clause is compatible with EU law.³³⁵ The issue of interest in this matter is the examination of the CJEU with regard to the compatibility between the LOB clause and the MFN principle. As already stated, the CJEU decided to compare two cross border situations in order to determine whether there was a discriminatory situation.³³⁶ Furthermore, this comparison could be questioned, as the assessment of whether the LOB clause is compatible with EU law regards vertical discrimination. As Guerra points out, the question is why the CJEU did not refer to the *Open Skies* cases, which did concern an LOB clause instead of using the reasoning similar to that of the *D* case, in which the CJEU instead dealt with the MFN treatment by comparing two cross border situations.³³⁷ O'Shea, on the other hand, did not find these cases comparable as the *Open Skies* cases concerned a nationality clause, while the *Act Group Litigation* case concerned a residency requirement. Furthermore, O'Shea argues that, since the clause in question does not constitute a nationality clause, all residents from the Netherlands are allowed equality in the Netherlands in case they are in a similar situation.³³⁸ The response of Guerra, who disagrees with O'Shea, is that a residency requirement may constitute an indirect discrimination based on nationality.³³⁹ Guerra also considers that the circumstance that the CJEU decided to focus on the controlling company, instead of the resident company that claimed the benefit, explained the fact that it referred to the *D* case instead of the *Open Skies* cases. Had the CJEU instead referred to the

³³¹ See, *inter alia*, C- 170/05, *Denkavit*. For further reading, see Debelva et. al., EC Tax Review Vol. 24 Issue 3 (2015), p. 136.

³³² C- 374/04 *Test Claimants in Class IV of the Act Group Litigation*, para. 86.

³³³ Opinion of AG Geelhoed in C- 374/04 *Test Claimants in Class IV of the Act Group Litigation*, finding 100.

³³⁴ C- 374/04 *Test Claimants in Class IV of the Act Group Litigation*, para. 91.

³³⁵ *Ibid*, para. 29.

³³⁶ *Ibid*, para. 83.

³³⁷ Guerra, *European Taxation* Vol. 51 No. 2/3 (2011), p. 88.

³³⁸ O'Shea, *International Tax Report* (2008), p. 2.

³³⁹ Guerra, *European Taxation*, 2011 (Volume 51), No 2/3 p. 88.

resident company claiming the benefit, no MFN issue would arise since the company then would be a resident of one of the contracting states.³⁴⁰ Hence, it is important to note that the companies that should have been compared were a Dutch company with Dutch shareholders and a Dutch company with foreign shareholders. Therefore, it could be questioned why the CJEU made a horizontal comparison of companies in two different Member States.³⁴¹ The CJEU could instead have referred to the *Open Skies* cases and ruled that the companies were being comparable regardless of the residence state of their shareholders.³⁴²

However, in order to continue the analysis of how the CJEU referred to the *D* case when analysing an LOB issue, it should be mentioned that difficulties may occur in combining the LOB clause with the MFN principle as they serve different purposes. While the MFN treatment intends to create a benefit for the taxpayer by reducing the taxation rights of a state, the application of the LOB clause results in reinforced taxation rights of a state and is restrictive for the taxpayer.³⁴³ Hinnekens is of the opinion that the application of the MFN treatment on the LOB clause would result in the of jeopardizing the LOB clause.³⁴⁴ Hence, that would constitute a risk for the tax treaty of being exposed to treaty shopping and would also distort the integrity of the tax treaty system. On the other hand, the result of denying the application of the LOB clause or allowing the MFN treatment is the same since the person who were not originally allowed the treaty benefits will be entitled the benefits according to the principle of non discrimination in the EU.³⁴⁵

Since tax treaties are bilateral in their nature, it is reasonable that they do not contain MFN clauses as a natural part and that such clauses might be harmful to the treaty network.³⁴⁶ The aim of the taxpayer by claiming the application of the MFN principle is not to extend the LOB clause but rather to extend another treaty provision according to which residents of the contracting states are granted a benefit. Another difference between the LOB clause and the MFN principle is that the MFN principle becomes applicable when two cross border situations are objectively comparable.³⁴⁷ As the CJEU ruled in the *D* case, the fact that the benefit constituted an inseparable and integral part of the tax treaty and contributed to its overall balance meant that the two cross border situations were not considered to be objectively comparable.³⁴⁸ In order to assess whether the LOB clause is discriminative, on the other hand, home state residents are being compared with host state residents. If a non resident person is being treated more

³⁴⁰ Ibid, p. 89. See also C- 374/04, *Test Claimants in Class IV of the act group litigation* para. 90.

³⁴¹ Debelva et. al., EC Tax Review Vol. 24 Issue 3 (2015), p. 136.

³⁴² Ibid p. 137.

³⁴³ Zester, Intertax Vol. 34 Issue 3 (2006), p. 143.

³⁴⁴ Hinnekens, EC Tax Review Vol. 4 Issue 4 (1995), p. 230.

³⁴⁵ Zester, Intertax Vol. 34 Issue 3 (2006), p 149.

³⁴⁶ Guerra, European Taxation Vol. 51 No. 2/3 (2011), p. 88.

³⁴⁷ Zester, Intertax Vol. 34 Issue 3 (2006), p. 148.

³⁴⁸ C- 376/03, para. 61.

beneficial than a non resident person not covered by that tax treaty, it could be argued that no discrimination will be present as the two cross border situations are not objectively comparable. Thus, the LOB clause may not be considered as being discriminative either, since the Member State is not obliged to extend its benefit to the non resident person not covered by that tax treaty. As Guerra considers, the LOB clause may not have had any impact on the decision of the CJEU that the provisions in question were not held to be discriminatory. The LOB clause restricts the granting of a tax benefit why it does not constitute a tool to avoid discrimination.³⁴⁹

³⁴⁹ Guerra, *European Taxation* Vol. 51 No. 2/3 (2011), p. 88.

6 Has the CJEU finally accepted the MFN treatment in the *Sopora* case?

The essence of the *Sopora* case is that it deals with horizontal discrimination, thus, discrimination between two non residents.³⁵⁰ In the *Sopora* case, according to the Dutch legislation, the reimbursements to cover extraterritorial expenses with regard to incoming workers residing at a distance of more than 150 kilometres from the Netherlands border were exempt from tax in an amount up to 30 per cent of the taxable base. A flat-rate rule was applied and no proof had to be established. An incoming worker not residing at a distance of more than 150 kilometres from the Netherlands border would need to provide proof in order to be granted an exemption regarding extraterritorial costs actually incurred.³⁵¹ The question referred to the CJEU was whether the distance criterion constituted a distinction between two comparable situations.³⁵² The CJEU ruled that the national legislation in question was not contrary to the freedom of movement for workers. However, that would not be the case if the set limits would, systematically, give rise to an overcompensation regarding the actually incurred extraterritorial expenses.³⁵³

In ruling on the horizontal discrimination, the CJEU took the view that discrimination between non resident workers are prohibited in case workers of some Member States are being “unduly favoured” compared to workers from other Member States. That reasoning derived from the wording of Article 45(2) of the TFEU, which has the intention to eliminate any discrimination in respect of workers of different Member States on the basis of nationality, in the light of Article 26 of the TFEU.³⁵⁴ Thus, the CJEU ruled in adjunction with the opinion of Advocate General Kokott with regard to the question on horizontal comparability that there is a possibility for horizontal discrimination, which has to be justified in order to be compatible with the EU law.³⁵⁵ However, unlike the CJEU, Kokott analysed whether the 150 kilometre criterion reflected the worker’s extraterritorial expenses.³⁵⁶

³⁵⁰ Meussen, European Taxation Vol. 54 No. 7 (2014), p. 322.

³⁵¹ C- 512/13 *Sopora*, para. 6.

³⁵² *Ibid*, para. 20.

³⁵³ *Ibid*, 36.

³⁵⁴ *Ibid*, para 25.

³⁵⁵ *Ibid*; Opinion of Advocate General Kokott in C- 512/13 *Sopora*, para. 23 & CFE ECJ Task Force, European Taxation Vol. 56 No. 2/3 (2016), p. 96.

³⁵⁶ Opinion of Advocate General Kokott in C- 512/13 *Sopora*, finding 53. See also CFE ECJ Task Force, European Taxation CFE ECJ Task Force, European Taxation Vol. 56 No. 2/3 (2016), p. 95.

Significant attention was paid to the objective of the national legislation. The legislation at issue enables the free movement of workers by applying the flat rate rule in respect of workers residing in other Member States and who are likely to suffer additional expenses.³⁵⁷ The CJEU also accepted the view that there would be no possibility for workers residing beyond a certain distance in another Member State from their work place in the Netherlands to commute on a daily basis. Therefore, they would incur significant additional living expenses.³⁵⁸ Administrative simplification was also a matter taken into account in justifying the rules in question.³⁵⁹ Kokott, on the other hand, reasoned that the prevention of distortions of competition between non resident workers would justify the 150 kilometre condition.³⁶⁰ The CJEU also accepted the view that the flat rate rule never operates in any disadvantage to the workers to which it applies. In case the extraterritorial expenses actually incurred exceed 30 per cent, a possibility remains to be granted an exemption on the reimbursement regarding extraterritorial expenses in case proof can be provided.³⁶¹ The flat rate rule also allows overcompensation with regard to workers fulfilling the 150 kilometre criterion. However, such overcompensation would not be allowed to workers not fulfilling the 150 kilometre criterion.³⁶² The CJEU emphasised that it is an “inherent aspect” of allowing such tax benefit, based on a flat rate rule, which is considered to cover situations where the material conditions have been satisfied indubitable, that there will be other situations, in which the conditions also have been satisfied, where the right to a tax advantage will be granted if appropriate evidence can be provided.³⁶³

Vertical discrimination between residents and non residents were not at issue in the case since only incurred extraterritorial costs can get reimbursed. To compare the *Sopora* case with the *D* case, the issue results from the application of a unilateral legislation on two groups of non residents instead of the application of two different tax treaties.³⁶⁴ The reasons for why the Dutch legislation contained provisions regarding the distance criteria was because of the necessity to prevent distortions of competition and to limit the use of the concept, since residents residing within the 150 kilometres distance do only incur limited extraterritorial costs.³⁶⁵ However, as Gerard Meussen highlights, such flat rate rules result in arbitrary outcomes which contributed to making the system unstable.³⁶⁶ Certainly, in accordance with the opinion of Advocate General Kokott, workers who reside within 150 kilometres from the border but have a greater distance to their work place in the Netherlands will be excluded from

³⁵⁷ C- 512/13 *Sopora*, para. 26.

³⁵⁸ C- 512/13 *Sopora*, para. 27.

³⁵⁹ *Ibid*, para. 33.

³⁶⁰ Opinion of Advocate General Kokott in C- 512/13 *Sopora*, findings 45-47.

³⁶¹ C- 512/13 *Sopora*, para. 28.

³⁶² *Ibid*, 29.

³⁶³ *Ibid*, para. 32.

³⁶⁴ Meussen, *European Taxation* Vol. 54 No. 7 (2014), p. 324.

³⁶⁵ C- 512/13 *Sopora*, para. 15.

³⁶⁶ Meussen, *European Taxation* Vol. 54 No. 7 (2014), p. 324

the benefits deriving from the flat rate rule why the sense of justice with regard to the ruling of the CJEU could be questioned.³⁶⁷

To conclude, the CJEU took the same standpoint as Kokott and reasoned that the freedom of movement for workers also prohibits discrimination between non-residents.³⁶⁸ Hence, Article 45(2) of the TFEU prohibits horizontal discrimination, which stipulates the “abolition of any discrimination based on nationality between workers of the Member States”. The question of whether horizontal discrimination is also prohibited by Articles 49, 56 and 63 of the TFEU lacks clarity.³⁶⁹ The fact that the CJEU has referred to horizontal discrimination in the *Cadbury Schweppes*³⁷⁰ case and the *Orange European Smallcap Fund*³⁷¹ case, which dealt with freedom of establishment, indicates that the prohibition of horizontal discrimination, and thus, the acceptance of a MFN principle within the EU, could be extended to all freedoms.³⁷²

³⁶⁷ Opinion of Advocate General Kokott in C- 512/13 *Sopora*, finding 51.

³⁶⁸ Ibid; C- 512/13 *Sopora*, para. 25.

³⁶⁹ See CFE ECJ Task Force, European Taxation Vol. 56 No. 2/3 (2016), p. 97.

³⁷⁰ C-196/04 *Cadbury Schweppes*, para. 45.

³⁷¹ C-194/06 *Orange European Smallcap Fund*, para 56.

³⁷² CFE ECJ Task Force, European Taxation Vol. 56 No. 2/3 (2016), p. 97.

7 Final remarks

7.1 Does EU law contain a principle of MFN treatment?

The principle of MFN treatment constitutes one of the guiding principles in GATT, why it is central in the context of trade law with the aim of providing undistorted import and export between different markets. Such a principle does not constitute a natural part of tax treaties, since they are bilateral. As most tax treaties do not contain an MFN clause, the question is to what extent EU law may oblige Member States to extend a treaty benefit granted to one contracting state to another, non contracting state.

The aim of the EU is, among other things, to create an internal market, why the EU law has a significant impact on the national law of different Member States. This is also the case regarding provisions included in bilateral tax treaties. The EU law does not determine the connecting factors for the purposes of allocating the powers of taxation of the Member States, so the Member States remain competent, both unilaterally and bilaterally, to determine the criteria on which their jurisdiction of taxation will be determined. However, Member States must still comply with the EU law. As the CJEU ruled in *Saint Gobain*, it would not impose any new obligations on the non Member States by extending the treaty benefit to the permanent establishment in Germany. Likely, however, the CJEU takes into account whether such extension would affect the functioning of the applicable tax treaties. This might be the reason that the CJEU ruled differently in *Saint Gobain* compared to the ruling in the *Gilly* case. In the *Gilly* case, the tax treaty was based on the OECD Model, which has played an important role in harmonizing the system of tax treaties. However, it is clear that, although the Member States are free to allocate their powers of taxation, they must not impede the right of freedom of movement within the EU. Hence, in case a principle of MFN treatment is contained in the EU law, the tax treaties must not infringe on that either. Furthermore, the question is whether the MFN principle prevails over the freedom to conclude contracts.

The TFEU does not explicitly, according to a systematic method of interpretation of the fundamental freedoms, oblige the Member States to enact an MFN treatment. It is clear that the prohibition of discrimination based on nationality contained in Article 18 of the TFEU covers vertical discrimination between residents and non residents, which requires a national treatment. The question remains whether Article 18 of the TFEU also prohibits horizontal discrimination. The reason for not accepting an obligation of an MFN treatment of Member States is that it may undermine the balance and reciprocity of the tax treaties. On the other hand, the only difference between horizontal and vertical discrimination is the

comparability element. Treating all nationals and residents of the EU equally would generate capital import neutrality, which certainly would result in fair competition between non resident companies. Accordingly, such result would be beneficial for the internal market. The basic principle of the aim of creating of an internal market is implemented in Article 26 of the TFEU. A teleological interpretation of the fundamental freedoms would also be in line with this principle. On the other hand, the MFN principle does not take into account the bilateral character of “give and take” that tax treaties are built upon. It would undermine the sovereignty of the Member States since an MFN treatment would restrict the freedom to conclude contracts, which might contravene the fact that Member States remain competent to bilaterally determine the criteria on which their jurisdiction of taxation will be determined.

Kemmeren considered that EU law does not contain an MFN principle after the ruling of the *Bachmann* case. However, the issue of horizontal discrimination has occurred in subsequent case law. The core of the principle of MFN treatment is the existence of horizontal discrimination meaning that the situations that must be comparable in order to determine whether such a situation exists are two cross border situations. In *Cadbury Schweppes*, the CJEU ruled that a Member State must treat two non residents being in an objectively comparable situation equally with regard to a domestic measure such as the CFC legislation, which was at issue in the case. In *Columbus Container Services*, on the other hand, the CJEU did not regard the difference in the treatment of two cross border situations sufficient reason to constitute discrimination, since the Member States enjoy certain autonomy. However, cautiousness should be taken with regard to the ruling since the German law at issue did not actually infringe the internal market. Consequently, if a Member State applies a domestic measure that results in an unequal treatment between two cross border situations that are objectively comparable, that measure is likely to constitute an infringement of the EU law. Hence, the same treatment should be applied to both non resident entities.

The CJEU has ruled somewhat differently in cases concerning the application of a tax treaty. In the *D* case and in the *ACT Group Litigation* case, the comparison at issue concerned two non residents being party to different tax treaties. In such a situation, the CJEU ruled that they were not considered to be in a comparable situation since the reciprocal rights and obligations applicable to persons that are covered by the tax treaty, is the inherent consequence of bilateral tax treaties. On the one hand, the decision of the CJEU is plausible since the tax benefit in question constituted an integral part of the tax treaty and contributes to its overall balance. Should the Member States in such case be obliged to extend their benefits to residents of non contracting states, the bilateral character of tax treaties would be frustrated. This is also the issue with treaty shopping situations. On the other hand, why should not any discrimination be prohibited in order to be in line with the aim of the EU to create an internal market without boundaries? The difference in treatment refers to the two identical capitals

that derive from two different Member States. Should unequal treatment be allowed just because it is based on a provision included in a tax treaty? As the CJEU held in *Avoir Fiscal*, equal treatment must not depend on the reciprocity of the tax treaties.

The two cross border situations that were assessed in the *OESF* case were not considered as being objectively comparable. However, as De Groot reasons, the fact that the CJEU noted that the Dutch legislation made investments in certain Member States less attractive than in other Member States in which the concession in question is granted indicates that the standpoint of the CJEU is that a distinction between two cross border situations constitutes a restriction on fundamental freedoms. The case in question differs from the *D* case since it concerned the application of a domestic measure in combination with a tax treaty.

In the *Sopora* case, the CJEU took a stance with regard to horizontal discrimination. The measure at issue did not concern the provisions of the tax treaty, but took issue with the Dutch legislation. The Dutch legislation was not considered to be contrary to the freedom of movement of workers unless the system would give rise to overcompensation with regard to the actually incurred extraterritorial expenses. However, horizontal discrimination between non resident workers is prohibited within the EU in case some workers from some Member States are being “unduly favoured” compared to workers from other Member States. The CJEU based its reasoning on Article 45(2) of the TFEU, with the intention to eliminate any discrimination between workers based on nationality, in adjunction with Article 26 of the TFEU. This standpoint of the CJEU implies that discrimination between non resident workers is prohibited. Regarding the remaining freedoms, it is uncertain whether they also cover horizontal discrimination. The fact that horizontal discrimination was referred to in *Cadbury Schweppes* and *OESF* regarding the freedom of establishment indicates that the principle of MFN treatment should be extended to all freedoms. By referring to the aim of creating an internal market, it could be argued that this reasoning should be applied also to benefits that are granted under a tax treaty, such as the situation in the *D* case and the *ACT Group Litigation* case.

Furthermore, since bilateral tax treaties must comply with EU law, and since the CJEU has ruled that horizontal discrimination is prohibited with regard to nationals and residents within the EU, it could be concluded that tax treaties must apply an MFN treatment in cases where two non resident taxpayers are considered to be objectively comparable. Hence, the MFN treatment should not be applied in a general manner, but every case must be assessed based on its own set of facts. Hence, the essential part to consider is the comparability analysis. The CJEU does not seem to neglect the application of the principle of MFN treatment within the EU. The question remains why the CJEU has considered the reciprocal nature of bilateral tax treaties as a reason to not consider a non resident of a contracting state being in a comparable situation to a non resident of a non contracting state.

7.2 Can the principle of MFN treatment apply to the LOB clause?

The question to be answered is whether the MFN principle can be applied in cases where a tax treaty includes an LOB clause. The question is of significant importance since the EU law prevails over BEPS, which constitutes soft law. The LOB clause intends to prevent the improper use of tax treaties and, in particular, treaty shopping, since the claiming of treaty benefits in situations where they are not intended undermines the tax sovereignty. Furthermore, in order to be granted a benefit under the LOB clause, it is not sufficient that a taxpayer is a resident of the contracting state. In addition, it must also constitute a “qualified person” by satisfying one of the objective tests in the LOB clause. Consequently, the LOB clause does not take into account the intention of the taxpayer to become a resident of a contracting state. It is important to note that, if a person constitutes a “qualified person”, they will automatically be entitled to all benefits provided by the tax treaty. Conversely, the LOB clause limits the scope of the tax treaty in case the taxpayer does not satisfy one of the tests. Since non-qualifying residents cannot claim the treaty benefit under the same conditions as residents, they are in an unfavourable position and should be subject to a vertical comparison.

In order to assess whether a Member State must enact MFN treatment in order to avoid creating a horizontal discrimination between two cross-border situations, the course of action of the CJEU in order to rule on the question instead refers to a horizontal comparison. The subsequent question that arises is, are the two concepts even comparable? They seem to focus on two different levels. The vertical comparison regarding the LOB clause focuses on assessing whether a resident person constitutes a person who should be entitled to treaty benefits. In order to do so, a resident company with a resident shareholder is being compared to a resident company with non-resident shareholders. The MFN treatment focuses on comparing whether two cross-border situations are comparable. Hence, should a treaty benefit entitled to a non-resident taxpayer be extended to another non-resident taxpayer? The focus is not on a company resident in a contracting state.

The LOB clause may be contrary to EU law, which will not be further analysed in this thesis, however, the question arises as to whether discrimination caused by the LOB clause in such a case would be remedied by the application of the MFN treatment? Are the two concepts possible to compare at all? The opinion of Hinnekens is that the MFN treatment should not apply to the LOB clause, which in such a case would be jeopardized.

In the *ACT Group Litigation* case, the CJEU ruled on the questions regarding both the MFN treatment and the LOB clause. In ruling on the compatibility of the LOB clause with EU law, it referred to the *D* case in its ruling regarding the MFN treatment. The result was that the CJEU rejected the MFN treatment between the Member States in the EU and accepted the

applicability of the LOB clause. This ruling is somewhat remarkable. Why did the CJEU refer to the *D* case which dealt with the horizontal comparability analysis when assessing the issue of the LOB clause? The question relating to the LOB clause was not whether a benefit could be extended to a non contracting state, which was at issue in the *D* case. Rather, the question was whether the LOB clause created a discriminatory situation between residents established in the same contracting state with shareholders resident in different Member States. The fact that the CJEU, when ruling on the LOB clause, referred to the *D* case creates the question of whether the MFN treatment and the LOB clause actually can be assessed together. In its ruling, the CJEU held that the scope of tax treaties is limited to the persons referred to in it and that a tax credit constitutes an integral part of the tax treaties. A resident of a non contracting state could not be compared to a resident of a contracting state, which gives rise to a situation of horizontal comparability.

Furthermore, when ruling on the compatibility of the LOB clause with EU law, why did the CJEU decide not to refer to the *Open Skies* cases, which was a case dealing directly with the LOB clause? The answer of that question is that the CJEU focused on the company controlling the company claiming the benefit. The latter company was a resident of a contracting state. Had the focus instead been on that company, no MFN issue would have occurred. When assessing the compatibility of the LOB clause with the fundamental freedoms, the comparability should have been at the level of the company claiming the benefit, and not the level of the shareholders. Had that been the case, the CJEU should have referred to the *Open Skies* since no MFN issue would have been at stake as the company constituted a resident of a contracting state. Hence, the reason that the MFN treatment was at issue might have been because the CJEU focused on the controlling company. On the other hand, when ruling on the compatibility of the LOB clause with EU law, the CJEU should not refer to the *Open Skies* cases since the legal issue in those cases concerned a nationality clause similar to the LOB clause and not the MFN treatment. This indicates that the obligation of a Member State to enact the MFN treatment and the refusal of the LOB clause should be subject to different comparability analyses.

By referring to the *D* case, it could be argued that in case a non resident taxpayer covered by a tax treaty is being treated more favourably than a non resident taxpayer not covered by that tax treaty, the two situations would not be objectively comparable and no discrimination would be present. Since the Member State in such case is not obligated to extend the benefit to the non resident taxpayer not covered by the treaty, the LOB clause would not be discriminative either. In such case, the LOB clause and the MFN treatment do not violate one another.

As a conclusion, it could be argued that the MFN treatment does not rule out the application of the LOB clause. Firstly, they are subject to different purposes. The MFN treatment intends to extend the treaty benefit granted to taxpayers of a contracting state to a taxpayer of a non contracting state.

Hence, the MFN treatment is beneficial for the taxpayer. The LOB clause, on the other hand, intends to restrict benefits provided to resident taxpayers to the taxpayer that satisfies one of the tests in the LOB clause. The intent is to prevent treaty shopping. Additionally, the MFN treatment does not intend to extend the application of the LOB clause, but to extend the application of a benefit granted under the tax treaty in question. While the LOB clause will restrict the availability of the entire tax treaty, the extension of a tax treaty benefit, as a result of the MFN treatment, refers to a certain benefit. On the other hand, if the application of the LOB clause is neglected, that would lead to the same result as applying the MFN treatment since the taxpayer, in both cases, will be granted the tax benefit in question.

In light of the foregoing, the MFN treatment should not be applied as a remedy of an LOB clause that creates discriminatory effects. Hence, unlike the ruling of the CJEU in the *ACT Group Litigation* case, the analysis of the MFN treatment and the LOB clause should not be combined although the acceptance of the MFN treatment and the refusal of the LOB clause in a specific situation lead to the same result.

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