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# The Commission Proposal for a Directive on Double Taxation Dispute Resolution Mechanisms: Will it resolve the remaining double taxation issues within the EU?

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# Contents

<b>SUMMARY</b>	<b>1</b>
<b>PREFACE</b>	<b>2</b>
<b>ABBREVIATIONS</b>	<b>3</b>
<b>1.INTRODUCTION</b>	<b>4</b>
1.1 Introduction and background	4
1.2 Aims	5
1.3 Methods and materials	5
1.4 Delimitation	6
1.5 Outlines	6
<b>2. INTRODUCTION TO DOUBLE TAXATION</b>	<b>7</b>
2.1 The definition of double taxation	7
2.2 How to avoid double taxation at international level	8
<b>3.DOUBLE TAXATION IN THE EU</b>	<b>10</b>
3.1 Interest-Royalty Directive	10
3.2 Parent-Subsidiary Directive	11
3.3 Case-law from the Court of Justice of the European Union	12
3.3.1 <i>Juridical double taxation</i>	12
3.3.2 <i>Economic double taxation</i>	13
3.3.2.1 Thin capitalization rules	13
3.3.2.2 Transfer pricing	20
3.3.2.3 Exemption and credit method	24
3.4 Problem raised by the ATAD	27
3.4.1 <i>Introduction</i>	27
3.4.2 <i>Interest limitation rule</i>	28
3.4.3 <i>Exit taxation</i>	28
3.4.4 <i>GAAR</i>	29
3.4.5 <i>CFC rule</i>	30
3.4.6 <i>Hybrid mismatches</i>	31
<b>4. EXISTING MECHANISM TO RESOLVE DOUBLE TAXATION DISPUTES</b>	<b>33</b>
4.1 National legal remedies	33
4.2 Mutual agreement procedure in the tax treaties	33
4.3 The EU Arbitration Convention	34

<i>4.3.1 The function of the Arbitration Convention</i>	34
<i>4.3.2 The shortcomings of the Arbitration Convention</i>	36
<b>5.PROPOSED DIRECTIVE ON DOUBLE TAXATION DISPUTE RESOLUTION</b>	<b>39</b>
5.1 The scope of the Proposed Directive	39
5.2 The function of the Proposed Directive	39
5.3 Analysis	41
<b>CONCLUSION:</b>	<b>46</b>
<b>BIBLIOGRAPHY</b>	<b>47</b>
<b>TABLE OF CASES</b>	<b>50</b>

# Summary

Double taxation, which includes both juridical double taxation and economic double taxation, has been widely accepted that has an adverse impact on cross-border investment and leads to economic distortions and inefficiencies. In the EU, Member States usually conclude tax agreements with each other to avoid double taxation and most tax agreements are based on the OECD Model Tax Convention ('OECD MTC'). However, for the reason that the purpose of the OECD MTC is to provide a resolution to juridical double taxation in some respects, bilateral agreements are usually unable to resolve economic double taxation.

To protect the functioning of the single market, the European Union has taken some uniform measures to eliminate double taxation, including both substantive laws and procedural rules, for example, the Parent-Subsidiary Directive and the Arbitration Convention. However, they all have limited effects and therefore fail to provide broad protection to the taxpayers. The Court of Justice, on the one hand, has recognized that double taxation impedes the fundamental freedoms granted by the TFEU. On the other hand, it holds itself does not have the power to rule on the juridical double taxation as the result of which caused by the exercising in parallel by two Member States of their fiscal sovereignty. By contrast, economic double taxation resulting from discriminatory national rules is precluded by fundamental freedoms if such rules cannot be justified by overriding public interests.

The European Commission proposed a directive on double taxation dispute resolution mechanisms in October 2016 to improve the existing double taxation resolution mechanism. This thesis aims to identify the remaining double taxation issues which cannot be resolved by the current EU laws and to find out whether the Proposed Directive will provide a resolution to these issues.

# Preface

Firstly, I would like to thank my supervisors for the time they spent on tutoring my thesis.

Then my appreciation goes to my husband, Shengnan Zhuang, for his supporting during my whole master programme. I also want to thank my parents for their patient and love.

Last but not least, I am grateful to all professors and classmates of both European Business Law programme and European and International Tax programme.

# Abbreviations

ADRC	Alternative Dispute Resolution Commission
CFC	Controlled Foreign Company
CJEU /The Court	The Court of Justice of the European Union
EU	European Union
GAAR	General Anti-Abuse Rule
MAP	Mutual Agreement Procedures
OECD	Organisation for Economic Cooperation and Development
OECD MTC	Model Tax Convention on Income and on Capital
PE	Permanent Establishment
WHT	Withholding Tax

# 1.Introduction

## 1.1 Introduction and background

The globalization and the development of technology increase the cross-border activities by corporations. Once companies conduct business in more than one state, there may be a risk of double taxation. Because where there is a cross-border activity, two or more jurisdictions have the right to impose taxes. It has been well-recognized that double taxation is an impediment to free trade and an obstacle to the development of the economy. States have been worked together to struggle with double taxation issues. The remarkable job has been achieved is the OECD MTC<sup>1</sup>, which has been used as a model by many states when they are concluding double taxation agreements with each other.

The EU has been working on to build a stronger and more competitive economy to achieve job creation, growth, and investment. To obtain these objectives, a fair and efficient tax system needs to be developed. It has been observed that “a fair tax system is not only one that ensures that profits are actually taxed where they are generated but also one that ensures that profits are not taxed twice”.<sup>2</sup> Thus, the EU has implemented many laws to resolve double taxation between Member States, such as the Parent-Subsidiary Directive<sup>3</sup>, the Interest-Royalty Directive<sup>4</sup>, the Arbitration Convention<sup>5</sup>. However, the annual cases analysis of the Commission showed that there are still many cases prevented from entering existing mechanisms, which haven't been resolved at all.<sup>6</sup>

To improve the existing mechanisms, on 25 October 2016, the European Commission proposed a Directive on Double Taxation Dispute Resolution Mechanisms in the European Union, which aims to resolve double taxation on business income in all cases. The Proposed Directive is welcomed by the taxpayers. Because, in recent years, the policy of the EU has been focusing on the fight against tax evasion and tax avoidance, such as the adoption of

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<sup>1</sup> OECD, Model Tax Convention on Income and Capital 2014, OECD Publishing, 2015

<sup>2</sup> Proposal for a Council Directive on Double Taxation Dispute Resolution Mechanisms in the European Union, COM(2016) 686 final, 25.10.2016 [hereinafter “the Proposed Directive”], p.2

<sup>3</sup> Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, [2011] OJ L 345/8 [hereinafter “Parent-Subsidiary Directive”]

<sup>4</sup> Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, [2003] OJ L157/49 [hereinafter “Interest-Royalty Directive”]

<sup>5</sup> Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/463/EEC), [1990] OJ L225/10 [Hereinafter “Arbitration Convention”]

<sup>6</sup> the Proposed Directive, p.2

the Anti-Tax Avoidance Directive<sup>7</sup>. The Proposed Directive is the first time in a long time that the EU has turned back to the protection of taxpayer's rights.

## 1.2 Aims

The thesis investigates double taxation issue resolutions in the EU law perspective. More specifically, the thesis aims to find out whether the Proposed Directive is capable of resolving the remaining double taxation issues within the EU. To answer the question, the general background will be provided firstly, including what is double taxation and what are the enforced EU laws to resolve it. Then the thesis goes into the questions of what are the remaining double taxation issues and why the current mechanisms cannot resolve them. After identifying the problems of the existing mechanism and the unsolved double taxation issues, the thesis analyzes the Proposed Directive and try to find out whether it overcomes the shortcomings of the existing mechanism and whether it can resolve the remaining double taxation issues.

The thesis recognizes that there may be some potential risks of double taxation following the entering into force of the ATAD. To provide a comprehensive analysis of double taxation in the EU, the thesis also tries to identify the potential double taxation that may arise by the ATAD and find out whether the Proposed Directive can resolve these issues.

## 1.3 Methods and materials

This thesis employs the legal-dogmatic approach, which “concerns research current positive law as laid-down in written and unwritten European or (inter)national rules, principles, concepts, doctrines, case law and the literature.”<sup>8</sup> In this approach, the author begins with a review of the EU current law and how it has dealt with double taxation. In this part, the EU directives and the judgments from the CJEU will be given high attention. In the next part, the thesis delves into the double taxation issues resolution mechanism. The emphasis will be placed on the Arbitration Convention and the Proposed Directive.

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<sup>7</sup> Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, [2016] OJ L193/1 [hereinafter “ATAD”]

<sup>8</sup> S. Douma, ‘Legal Research in International and EU Tax Law’ (Kluwer, 2014), p.18



## 1.4 Delimitation

As the Proposed Directive only applies to the taxpayers that subject to one of the taxes on income from business listed in Annex I.<sup>9</sup> This thesis will not come to incomes from other areas, such as pensions, labour, inheritance.

The author acknowledges, double taxation not only occurs at international level but also at a purely national level, especially economic double taxation. As EU legislations only concern cross-border activities, the thesis not intends to cover domestic double taxation issues.

Moreover, the CJEU has ruled on double taxation issues more than what has been listed in this thesis. The author recognizes that it would be too much to cover all of them. Thus, only the issues mostly happened are analyzed.

## 1.5 Outlines

The thesis is divided into five parts. Following the introduction, chapter 2 serves to give the reader the background information of double taxation. After recognizing that double taxation refers to both juridical and economic double taxation, this chapter provides the general knowledge on these two kinds of double taxation and analyzes the similarities and disparities between them. The European Union has applied both substantive law and procedural rules to eliminate double taxation. Thus, chapter 3 is devoted to analyzing the EU substantive legislation and how they allocate tax power between Member States to avoid juridical and economic double taxation. As the ATAD is also a substantive law in the EU, the potential problems it may have in respect of double taxation are given in this chapter. Chapter 4 goes into current procedural rules, and the emphasis of this part is placed on the Arbitration Convention. In this part, the thesis provides a general overview of the function of the Convention and tries to identify the shortcomings of it. Chapter 5 dives into the analysis of the Proposed Directive.

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<sup>9</sup> The Proposed Directive, article (1)

# 2. Introduction to double taxation

## 2.1 The definition of double taxation

The notion of double taxation can be divided into juridical double taxation (also called “international double taxation”) and economic double taxation.

Juridical double taxation can be defined as the “imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical period”.<sup>10</sup> It mainly arises today because of the vast majority of countries, in addition to levying taxes on domestic assets and domestic economic transactions, impose taxes on capital situated and transactions carried out in other countries to the extent that they benefit resident taxpayers.<sup>11</sup> For example, based on the principle of residence, the worldwide income of a taxpayer is subject to taxation in the state where he/she is a resident. However, based on the principle of source, no state waives its taxation on the transactions or capital within its own territory even if they benefit, or belong to, non-resident taxpayers. Juridical double taxation can also arise in a situation of dual residence or source rules overlap.<sup>12</sup> For example, a company may be considered as a resident for tax purposes in a state in which it has been legally registered and, simultaneously, in a different state in which it develops its main activity. In that case, the company could potentially be obliged to pay corporation tax on a worldwide basis in both states and consequently pay tax on the same income twice.<sup>13</sup>

Economic double taxation is used to describe the situation that arises when “the same economic transaction, item of income, or capital is taxed in two or more states during the same period, but in the different taxpayers.”<sup>14</sup> Economic double taxation may occur where assets are attributed to different persons by the domestic law of the states involved, or a legal entity is subject to taxation in a state which it is a resident whereas another state disregards the legal entity and taxes its income or capital by attributing it to a resident shareholder.<sup>15</sup> Economic double taxation may also arise from conflicting rules regarding the inclusion or deduction of positive and negative elements of income and capital.<sup>16</sup>

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<sup>10</sup> Klaus Vogel on Double Taxation Convention (Kluwer 2015), p.1

<sup>11</sup> *ibid*, p.12

<sup>12</sup> *ibid*

<sup>13</sup> Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee Double Taxation in the Single Market, COM(2011) 712 final, p. 4

<sup>14</sup> Klaus Vogel on Double Taxation Convention (Kluwer 2015), p.12

<sup>15</sup> *ibid*, p.13

<sup>16</sup> *ibid*

From the international perspective, juridical double taxation and economic double taxation both imply that the same taxable income is taxed in more than one state. The disparity is that it is taxed at the same or different taxpayers. Juridical double taxation indicates two or more states impose taxes on the same taxpayer. By contrast, economic double taxation concerns different taxpayers subject to tax on same economic income. For example, a shareholder which is a resident in State A receives a dividend from a company which is a resident in state B. Juridical double taxation occurs when the shareholder is subject to WHT in the State B, and then income tax or corporation tax in the State A on the dividend received. In contrast, the economic double taxation occurs when the dividend is paid out of profits which have already been subject to corporation tax at the level of the company in the State B, and then the dividend is liable for income or corporation tax at the level of the shareholder.

Juridical double taxation and economic double taxation are also different in respect of the taxable income. Juridical double taxation concerns same income of one taxpayer, for example, one dividend income that subjects to tax in two states. By contrast, economic double taxation involves same economic income, which means different incomes that might economically be regarded as same taxable income. For example, corporate profit at the level of the company and dividend income at the level of the shareholder.

## **2.2 How to avoid double taxation at international level**

Double taxation can be unilateral avoided if one of the states concerned withdraws its tax claim. This unilateral move is often achieved whereby the residence state, allows a credit for the tax charged in the source state up to an amount equal to its own tax charge.<sup>17</sup> Other than credit, some states allow an exemption to avoid double taxation unilaterally. However, unilateral measures are not able to avoid double taxation satisfactorily because they are usually neither comprehensive nor mutually consistent.<sup>18</sup>

Therefore, states have concluded bilateral agreements with each other for the avoidance of double taxation. In most of the countries, treaties have same authority power as internal law. In some states, they are even considered to have priority over domestic law.<sup>19</sup> Numerous efforts have been contributing to the development of a uniform model of double taxation avoidance at international level. The most significant work is the OECD

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<sup>17</sup> Klaus Vogel on Double Taxation Convention, p.19

<sup>18</sup> *ibid*

<sup>19</sup> *ibid* p.28

Model Tax Convention, which serves as a model for states to conclude double taxation agreements with each other. The value of the OECD MTC has also been recognized by the Court of Justice. The Court consistently held out that “[i]t is for the Member States to take the measures necessary to prevent double taxation by applying, in particular, the apportionment criteria followed in international tax practice, including the model conventions drawn up by the OECD.”<sup>20</sup> However, the main purpose of the OECD MTC is to provide uniform measures to settle the most common problems that occur in the field of international juridical double taxation.<sup>21</sup> Therefore economic double taxation might not be resolved by bilateral treaties.

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<sup>20</sup> see for example Case C-524/04 Thin Cap GLO and C-414/06 Lidl Belgium

<sup>21</sup> OECD, Model Tax Convention on Income and Capital 2014 (full version), OECD Publishing, October 30, 2015, p.I-1

## 3. Double taxation in the EU

The European Union has recognized that to keep the single market attractive, it is essential to ensure that cross-border activities are not at a disadvantage compared with domestic activities. Neither discrimination nor double-taxation resulting from the transnational character of an operation can be tolerated in the internal market.<sup>22</sup> Therefore, some directives have been entered into force to provide a uniform measure to eliminate double taxation within the EU. Moreover, the CJEU has given preliminary rulings concerned double taxation in some circumstances.

In this part, the thesis will delve into the EU substantive legislation concerning double taxation. To do so, the Parent-Subsidiary Directive and the Interest-Royalty Directive will be reviewed firstly. Then some relatively common double taxation problems and the judgments from the CJEU will be analyzed. Finally, the thesis will discuss whether there would a risk of double taxation resulting from the adoption of the new Directive — ATAD.

### 3.1 Interest-Royalty Directive

Interest payment means that a certain amount of interest that the borrower pays to the lender on loan. The meaning of the term ‘interest’ has been described consistently in the OECD MTC and Interest-Royalty Directive. It means “income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payment shall not be regarded as interest.”<sup>23</sup>

Juridical double taxation frequently occurs when both states concerned impose taxes on the interest payment at the hands of the creditors. By contrast, economic double taxation arises when the state of the creditor imposes a tax on the interest payment while the state of the debtor does not allow a deduction from the profits of the debtor which have already subjected to corporation taxation.

The aim of the Directive is to protect the single market by ensuring that transactions between companies of different Member States should not be subject to less favorable tax treatment than those applicable to the same

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<sup>22</sup> Commission Staff Working Paper Company Taxation in the Internal Market, COM (2001) 582 final, p.284

<sup>23</sup> OECD, Model Tax Convention on Income and Capital 2014, OECD Publishing, 2015, article 11 and Interest-Royalty Directive, article 2

transaction carried out between companies of the same Member State.<sup>24</sup> For this purpose, interest shall only subject to tax once in a Member State.

Pursuant to the Article 1 of the Interest-Royalty Directive, “Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State.”<sup>25</sup> However, this Directive has limited applicable scope. It only applies to associated companies (a minimum 25% shareholding requirement) which are resident inside the EU and only to the direct beneficial owner of the interest. The benefit of this Directive may be withdrawn in cases of fraudulent or abusive transactions.<sup>26</sup>

Moreover, the purpose of this Directive is to resolve juridical double taxation concerning cross-border interest payment. As the CJEU held that, “it aims to prohibit the taxation of interest in the source Member State to the detriment of the actual beneficial owner. That provision concerns solely the tax position of the interest creditor.”<sup>27</sup> In that sense, the Interest-Royalty Directive does not eliminate economic double taxation.

## 3.2 Parent-Subsidiary Directive

The EU has adopted the Parent-Subsidiary Directive to provide a uniform way of preventing double taxation on dividend payment within the EU. The objective of it is to exempt the withholding tax charged on dividends and other profit distributions paid by subsidiary companies to their parent companies and to eliminate double taxation of such income at the level of the parent company.<sup>28</sup> The Directive provides measures to abolish both juridical double taxation and economic double taxation concerning dividend payment. As regards juridical double taxation, profits which a subsidiary distributes to its parent company shall be exempt from WHT.<sup>29</sup> As regards economic double taxation, the Directive provides that the parent company either, “refrain from taxing such profits” or “tax such profits but while authorizing the parent company to deduct from the amount of tax due that fraction of the corporation tax related to those profits and paid by the subsidiary.”<sup>30</sup>

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<sup>24</sup> Interest-Royalty Directive, recital 1

<sup>25</sup> *ibid*, article 1(1)

<sup>26</sup> *ibid*, article 5

<sup>27</sup> C-397/09 Scheuten ECLI:EU:C:2011:292, para. 28

<sup>28</sup> Parent-Subsidiary Directive , recital 3

<sup>29</sup> *ibid*, article 1

<sup>30</sup> *ibid*, article 5

This Directive provides that, to apply this directive, the parent company in a Member State shall have a minimum holding of 10% in the capital of a subsidiary in another Member State. As the Parent-Subsidiary Directive applies only to associated companies, it does not cover non-associated companies or individual shareholders. Moreover, this Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse.

Overall, in respect of the payment of interests, royalties and dividends, the Parent-Subsidiary Directive and the Interest-Royalty Directive can eliminate double taxation to some extent. But there are still many cases cannot be resolved due to the limited scope of these two Directives.

## **3.3 Case-law from the Court of Justice of the European Union**

### **3.3.1 Juridical double taxation**

In the Kerckhaert-Morres<sup>31</sup>, Mr and Mrs Kerckhaert-Morres were residents in Belgium and subjected to worldwide taxation there. They received dividend income from France and such income was subject to WHT in France. Belgian tax authority rejected to grant a tax credit for the WHT they had paid. Mr and Mrs Kerckhaert-Morres argued the denying of the tax credit subjected them to a heavier tax burden than internal dividend payment. The Court of Justice rejected their argument and held that there was no different treatment between domestic dividend and inbound dividend as both of them were subject to income tax at an identical rate of 25%. As regards, the denying of tax credit, the Court stated that it was not precluded by the fundamental freedoms in the TFEU as “the adverse consequences ... resulting from the exercise in parallel by two Member States of their fiscal sovereignty”<sup>32</sup> and “Community law, in its current [situation], does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Community. Consequently, it is for the Member States to take the measures necessary to prevent situations such as that at issue in the main proceedings.”<sup>33</sup>

The Court continuously remains its position in the Kerckhaert-Morres in its following cases, for example, Damseaux<sup>34</sup> and Levy & Sebbag<sup>35</sup>. Therefore

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<sup>31</sup> C-513/04 Kerckhaert-Morres, ECLI:EU:C:2006:713

<sup>32</sup> *ibid*, para. 20

<sup>33</sup> *ibid*, para. 22, 23

<sup>34</sup> C-128/08 Damseaux, ECLI:EU:C:2009:471, para. 27

<sup>35</sup> Katharine Daxkobler and Eline Huisman, ‘Levy & Sebbag: The ECJ Has Once Again Been Asked To Deliver Its Opinion On Juridical Double Taxation in the Internal Market’, *European Taxation*, August 2013

the Court regards itself as unable to offer remedies against juridical double taxation.

### **3.3.2 Economic double taxation**

In comparison to the juridical double taxation, the Court holds different position concerning economic double taxation. Pursuant to the case-law, it can be concluded that national rules of Member States that give more favorable treatment to domestic situations as opposed to cross-border situations in the area of economic double taxation, are precluded by the fundamental freedoms, in the absence of pertinent justifications.<sup>36</sup> In the following, the CJEU's rulings on some common economic double taxation issues will be reviewed.

#### **3.3.2.1 Thin capitalization rules**

For tax purposes, the instruments that taxpayers employ to finance their businesses can either qualify as equity or debt. The distribution of the profits generated from equity instruments (for example, dividend) is generally not deductible at the level of the distributing entity, but may (partial) relief from economic double taxation by either credit or exemption method at the level of the shareholder.<sup>37</sup> In contrast, profits on debt instruments (for example, interest) is, in general, deductible at the level of the debtor while being taxable at the level of the creditor.<sup>38</sup> For intra-group companies, they have incentives to choose to finance their business through debt other than equity instruments in the reason that the debtor is able to reduce its taxable base, especially if the debtor locates in a high-tax jurisdiction. Such tendency leads to the reduction of the tax revenue in the debtor states. In order to protect their tax revenue, many countries have adopted so-called thin capitalization rules, which deny the tax treatment of debt instrument when a certain limit is exceeded.<sup>39</sup> The thin cap rules may lead economic double taxation if a Member State unilateral denies the deduction of interest expense. In the following, some of the case-law from the CJEU will be analyzed in order to find out to what extent the thin cap rules are contrary to the fundamental freedoms.

#### **Case C-324/00 Lankhorst-Hohorst<sup>40</sup>**

##### Legal background and facts

The German thin cap rules that applied from 1996 to 1998 provided that repayment in respect of loan capital, which a resident company received

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<sup>36</sup> Communication (n.13), p.5

<sup>37</sup> T.J.C. van Dongen Thin Capitalization legislation and the EU Corporate Tax Directive, p.1

<sup>38</sup> *ibid*

<sup>39</sup> *ibid*

<sup>40</sup> C-324/00 Lankhorst-Hohorst ECLI:EU:C:2002:749 [hereinafter "Lankhorst-Hohorst"]



from a shareholder not entitled to the imputation tax credit, which had a substantial holding of its shares at any point in the financial year, was regarded as a hidden profit distribution, where (i) a consideration calculated as a fraction of the capital was agreed and (ii) the loan capital was more than three times the proportional equity capital of the shareholder at any point in the financial year.<sup>41</sup> Unless the loan can be obtained from independent parties.

A shareholder not entitled to the imputation tax credit included both non-resident shareholders and German resident shareholders exempt from corporate income tax. German resident shareholders exempt from corporate income tax include the legal entities governed by public law and corporations carrying out business on specific fields or performing tasks that should be encouraged.<sup>42</sup>

Lankhorst-Hohorst (German subsidiary), was 100% owned by Lankhorst-Hohorst BV (LH BV, Dutch parent company), the sole shareholder of which was Lankhorst Taselaar BV (LT BV Dutch Grandparent company). LT BV granted an interest-bearing loan to Lankhorst-Hohorst in order for Lankhorst-Hohorst to reduce its bank borrowing and thus to reduce the bank interest charge. And in these years, Lankhorst-Hohorst suffered losses. The interest payment was captured as covert profit distribution in according with the German thin cap rules. Lankhorst-Hohorst challenged the decision of German tax authority in the reasons that the loan constituted a rescue attempt, and the German thin cap rules were discriminatory because the shareholders not entitled to the tax credit were mostly foreign companies. The German court requested a preliminary ruling on the compatibility of German thin cap rules from the ECJ.

#### Restriction and justifications

The Court held that although the deductibility of interest paid was based on the entitlement to a tax credit, not the seat of the parent company, the effect of the rules actually same.<sup>43</sup> The German parent companies not entitled to a tax credit were those being governed by public law or carry out activities of common interest. Those entities were not comparable to the parent company of Lankhorst-Hohorst which was a profit-oriented company. The actual fact of the rules was that interest paid to a resident company was deductible, but to a non-resident company was not deductible and was treated as covert profit distribution. Such different treatment makes it less attractive for companies to established in other Member States. Thus it is prohibited by the freedom of establishment in the TFEU.

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<sup>41</sup> Lankhorst-Hohorst, para. 2

<sup>42</sup> *ibid*, para. 4

<sup>43</sup> *ibid*, para. 31

The restriction is permissible if it can be justified by overriding public reasons and the national rule must be appropriate for ensuring attainment of the objective pursued and must not go beyond what is necessary to achieve that objective.

The German government put forward, first, the risk of tax evasion. It was argued that the rules were designed to counter tax evasion by preventing the profits from shifting from where they were generated to low-taxation jurisdiction. And there was an exception if the company concerned could prove that the loan can be obtained from independent parties. The Court rejected the holdings in the reasons that the legislation at issue did not have the specific purpose of preventing wholly artificial arrangements, designed to circumvent national tax legislation concerned, but applied generally to any situation in which the parent company has its seat, for whatever reason, outside Germany.<sup>44</sup> Moreover, no abuse had been found in the present case, Lankhorst-Hohorst suffered a loss in 1996, 1997 and 1998, the loan had been granted by its parent company was to assist Lankhorst-Hohorst to reduce the interest burden resulting from its bank loan.<sup>45</sup>

Second, it was argued that the restriction could be justified by the need to ensure the coherence of the applicable tax systems as the provisions were in accordance with arm's length principle. Because in *Bachmann*<sup>46</sup> the Court held that the need to ensure the coherence of the tax system could justify national rule which restricted the free movement of person. However, this justification was rejected by the Court. In *Bachmann* there was "a direct link between deductibility of pension and life assurance contributions and taxation of the sums received under those insurance contracts and preservation of that link was necessary to safeguard the coherence of the relevant tax system".<sup>47</sup> There was no such direct link in this case because the German government did not provide any tax advantage to offset the less favorable treatment suffered by the subsidiaries of non-resident companies.<sup>48</sup>

Third, to ensure the effectiveness of fiscal supervision. However, the German government failed to submit any argument on how the provision enabled the German tax authorities to supervise the amount of taxable income.<sup>49</sup>

Remark: it is clear from this case that thin cap rules resulting in economic double taxation constitute a restriction on fundamental freedoms if the rules, by object or effect, treat the internal and cross-border situations differently.

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<sup>44</sup> Lankhorst-Hohorst, para. 37

<sup>45</sup> *ibid*, para. 38

<sup>46</sup> C-300/90 *Bachmann* ECLI:EU:C:1991:340

<sup>47</sup> Lankhorst-Hohorst, para. 42

<sup>48</sup> Lankhorst-Hohorst, para. 42

<sup>49</sup> Lankhorst-Hohorst, para. 48

And it cannot be justified by the prevention of tax avoidance if it is not specified at preventing wholly artificial arrangement.

### **C-524/04 Test Claimants in the Thin Cap Group Litigation<sup>50</sup>**

Following the Lankhorst-Hohorst, the UK national court requested a preliminary ruling on the compatibility of the UK thin capitalization rules from the Court of Justice. Following UK's rules, generally, the interest payments from a resident subsidiary to an associated company outside the UK may be recharacterized as profit distributions.

The UK government argued that the fundamental provision shall not apply because the UK rule was the exercise of Member States's fiscal competence as allocated in accordance with international-recognized principle (arm's length principle in OECD MTC) in the tax treaties.<sup>51</sup> Under this principle, where the transaction is entered into arm's length terms, it is the State in which the lending company is resident has the right to tax the interest received, whereas where the transaction is not in line with arm's length terms, the right to do so belongs to the State in which the borrowing company situates.<sup>52</sup> Also most of the double tax agreements including a provision permitting the corresponding competent authority to agree on a compensating adjustment, therefore any increase in taxable profits in the State of the borrowing company can be offset by a corresponding reduction in taxable profits in the State in which the lending company is established.<sup>53</sup>

The Court rejected the argument by stating the national provisions at issue in the main proceedings were not concerned only with the allocation of powers between the UK and its contracting partner. Because rather than seeking to avoid double taxation, the national rule reflected the choice made by that Member State to organize its tax system to prevent profits from being untaxed in that State through a system of thin capitalization.<sup>54</sup> As the opinion from the Advocate General, the unilateral nature of the provisions treating certain interest paid to non-resident companies as a distribution is negated neither by the fact that Member State did so on the basis of internationally-recognised principles nor that it sought to ensure compensation adjustments for the avoidance of double taxation under its tax treaties.<sup>55</sup> Moreover, even if the provision is implementing criteria laid down in DTCs, Member States are obliged to comply with the Community law when they are exercising the powers of taxation allocated under them.<sup>56</sup>

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<sup>50</sup> C-524/04 Test Claimants in the Thin Cap Group Litigation ECLI:EU:C:2007:161 [hereinafter "Thin Cap Group"]

<sup>51</sup> *ibid*, para. 46,47

<sup>52</sup> *ibid*, para. 47

<sup>53</sup> *ibid*, para. 48

<sup>54</sup> *ibid*, para. 51

<sup>55</sup> *ibid*, para. 52

<sup>56</sup> *ibid*, para. 53

As regards whether the restriction can be justified, the Court accepted justification of the prevention of tax avoidance, as the UK rules specifically targeted wholly artificial arrangements designed to circumvent the legislation of the Member State concerned. And the Court made a clarification concerning the requirements of national rules not going beyond what is necessary by obliging the legislation that shall provide for “a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, to be established and allows taxpayers to produce, if appropriate and without being subject to undue administrative constraints, evidence as to the commercial justification for the transaction in question”.<sup>57</sup> And “where it is established that such an arrangement exists, such legislation treats that interest as a distribution only in so far as it exceeds what would have been agreed upon at arm’s length”.<sup>58</sup>

Remark: the Court held the limitation on the deduction of interest paid is a unilateral measure other than the allocation of power between contracting States, and even if the national rules in accordance with the OECD principle, it nonetheless has to be compatible with EU Treaties. Also, in this case, it is clear that the thin cap rules can be justified by the prevention of tax avoidance if it meets the proportional test mentioned above.

#### **C-593/14 Masco Denmark and Damixa**<sup>59</sup>

As we can see above, the limitation on deduction of the thin cap rules, normally by object or effect, impose different treatment on the internal and cross-border situation, which is precluded unless can be justified by the need to prevent tax evasion. The rights of limitation on deduction of interest belong to the State in which the borrowing company is a resident. However, the thin cap rules on the State of the lending company may also be incompatible with EU Treaty.

#### Legislation and facts

Under Danish law, Danish companies are liable to pay tax on interest income in Denmark and are generally entitled to a deduction of interest expenditure. However, a company’s right to deduct interest expenses is limited in the event of thin capitalisation, where the ratio of the company’s debt in relation to its equity at the end of the tax year exceeds 4:1, interest expenses and losses relating to the excess part of the controlled debt cannot be deducted unless the company demonstrates the debt can be obtained between independent companies.<sup>60</sup> In order to prevent double taxation, the

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<sup>57</sup> Thin Cap Group, para. 92

<sup>58</sup> *ibid*

<sup>59</sup> C-593/14 Masco Denmark and Damixa ECLI:EU:C:2016:984 [hereinafter “Damixa”]

<sup>60</sup> Damixa, para. 5

interest income is tax exempt for its recipient. However, this provision only applies when the debtor company is also resident in Denmark.

Damixa (Danish Parent) is a Danish parent company holding all the shares in subsidiary Damixa Armaturen resident in Germany (German Subsidiary). Danish Parent had granted a loan to German Subsidiary in respect of which it received interest. German Subsidiary was not entitled to deduct the interest paid to Danish Parent due to German thin capitalization rules. The Danish tax authorities took the view that the interest received from German Subsidiary was taxable income for Danish Parent, although it would have been tax exempt if received from a subsidiary resident in Denmark. Danish Parent appealed the decision arguing that disallowing the exemption was against the freedom of establishment as the exemption was denied only because the interest was received from a subsidiary resident in another Member State. The Danish courts requested a preliminary ruling on this issue from the ECJ.

#### Restriction and justifications

The Court held that providing a tax exemption to a resident company in respect of the interest income it received from a resident subsidiary in so far as that subsidiary is not entitled to a tax deduction for interest payment due to the national thin cap rules constitutes a tax advantage.<sup>61</sup> Denying such an advantage for a resident company in relation to interest received from a subsidiary resident in another Member State is liable to render less attractive the exercise by that parent company of its freedom of establishment by deterring it from setting up subsidiaries in other Member States.<sup>62</sup>

Such a different treatment is permissible only if it relates to situations which are not objectively comparable or if it can be justified by an overriding reason in the public interest.<sup>63</sup> The Court held that they are objectively comparable because, in both of the cases, the interest income received by the parent company is liable to be subject to economic double taxation or to a series of charges, which is what the legislation at issue seeks to avoid.<sup>64</sup>

The Danish government submitted that the difference in treatment is justified both by the need to ensure a balanced allocation of tax powers between the Member States and by the need to prevent tax avoidance.

The Court accepted the first justification because if the tax exemption shall be allowed in relation to the interest paid by a non-resident subsidiary where the subsidiary is not entitled to deduct the interest expenses due to thin cap rules of that other Member State, the tax rights on the interest income of the

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<sup>61</sup> Damixa, para. 26

<sup>62</sup> *ibid*, para. 27

<sup>63</sup> *ibid*, para. 28

<sup>64</sup> *ibid*, para. 31

Member State of the parent company would depend on the thin cap rules of other Member States. The legislation in question ensures the balanced allocation of taxing powers between Member States by limiting the tax exemption solely to interest paid by a resident subsidiary.<sup>65</sup>

However, the national legislation in question goes beyond what is necessary to achieve the objective of the national law. Although a Member State is not required to draw up its tax rules on the basis of those in another Member State in order to remove disparities arising from national tax rules,<sup>66</sup> it must treat cross-border situations the same way as internal situation where it has a system to prevent or mitigate a series of charges to tax or economic double taxation.<sup>67</sup> Hence, a less restrictive measure in line with the balanced allocation of taxing powers would be to provide a tax exemption to the parent company for interest paid by the subsidiary resident in another Member State up to the amount that the subsidiary was not entitled to deduct under the thin capitalization rules of that another Member State.<sup>68</sup>

The ECJ rejected the justification of the need to prevent tax evasion in the reason that the legislation at issue does not specifically aim at preventing wholly artificial arrangements but generally excludes all resident companies that have granted, irrespective of the reason, a loan to a thinly capitalized subsidiary resident in another Member State. In the case at issue, it was also clear that the loan Danish Parent granted to German Subsidiary was to finance the latter which was in major financial difficulties. Therefore, the loan arrangement did not constitute a wholly artificial arrangement entered into only for tax reasons.

Remark: in this case, where a Member State employs a system for preventing or mitigating a series of charges to tax or economic double taxation, the system must treat the internal and cross-border companies in the same way. The different treatment may be justified by the need to ensure a balanced power to tax provided that the national rules exempt the amount that the subsidiary was not entitled to deduct under the thin capitalization rules of the residence state of the subsidiary.

## **Conclusion**

From the CJEU's case-law, it can be concluded although national thin cap rules may be in accordance with international principle or guideline, especially the OECD and arm's length principle, it constitutes a restriction on fundamental freedoms if the rule, by object or effect, treats the internal and cross-border situations differently. Moreover, when a Member State sets up a system for preventing economic double taxation, the system shall apply

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<sup>65</sup> Damixa, para. 38

<sup>66</sup> *ibid*, para. 40

<sup>67</sup> *ibid*, para. 42

<sup>68</sup> *ibid*, para. 43

to the internal and the cross-border transaction in the same way. The restriction may be justified by the need to ensure a balanced power to tax between Member States and the need to combat tax evasion. Nonetheless, in order to be justified, the national legislation shall not go beyond what is necessary, which implies that the national rules shall provide a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, and provide the taxpayer opportunities to prove that the transaction is genuine. Moreover, where it is established that such an arrangement exists, the legislation concerned shall treat the interest payment as a distribution only in so far as it exceeds what would have been agreed upon at arm's length.

### **3.3.2.2 Transfer pricing**

Economic double taxation in transfer pricing occurs when the tax administration of a Member State unilateral makes an adjustment on the price put on the cross-border transaction between associated companies, without this adjustment being offset by a corresponding adjustment in the other Member State.<sup>69</sup> In the result, the adjustment may subject to tax at the hand of a company in the first Member State as well at the hand of an associated company in the latter Member State. The transfer pricing adjustment may breach the freedoms of movement granted by the Treaties.

#### **C-311/08 SGI<sup>70</sup>**

##### Legislation and facts

Under the Belgian law applicable at the material time, where an undertaking established in Belgium granted unusual or gratuitous advantages, those advantages shall be added to its own profits, unless they were used to determine the taxable income of the resident recipients.<sup>71</sup> By contrast, where the recipient company was a non-resident, such advantages were included in the tax base of the Belgian company which granted those advantages and taxed accordingly.

SGI which is a resident in Belgium has a 65% holding in a company('Recydem') which is a resident in France. The interest-free loan granted by SGI to Recydem has been recognized as unusual or gratuitous advantages by Belgian tax authorities. Under the Belgian rules, a sum corresponds to notional interest calculated at an annual rate of 5% was added to the profits of SGI.

##### Restriction and justifications

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<sup>69</sup> Commission Staff Working Paper Company Taxation in the Internal Market, COM (2001) 582 final, p.10

<sup>70</sup> C-311/08 SGI ECLI:EU:C:2010:26 [Hereinafter "SGI"]

<sup>71</sup> SGI, para. 3

The Court held that the different tax treatment of unusual or gratuitous advantages, based on whether the recipient company was a resident or a non-resident, constituted a restriction on the freedom of establishment. Because the upward adjustment of the profits of the company granting these advantages could lead to economic double taxation of the advantages concerned, as these advantages could be taxed both at the level of the non-resident recipient company and the Belgian company.

The Belgian Government argued first the disadvantage from the economic double taxation was not attributable to Belgium, but to the other Member State, which rejected to make a corresponding downward adjustment. Second, that risk was greatly diminished by the fact that it was possible to apply the Arbitration Convention to eliminate double taxation. Accordingly, the difference in treatment based on the place where recipient companies have their registered office was less significant than it might appear.<sup>72</sup>

The Court rejected the observations of the Belgian government. The Court emphasizes that the company which grants unusual or gratuitous advantages and the company which receives these advantages are separate legal persons and they have their own individual tax liability. Thus, the tax burden borne by the recipient company in a domestic situation cannot be likened to the taxation, in a cross-border situation, of the company granting the advantage.<sup>73</sup> Concerning the risk of double taxation could potentially be mitigated through the Arbitration Convention, the Court rejected this argument for the reason that the relevant procedures are lengthy and the taxpayer must bear the burden of double taxation during the course of such procedures.<sup>74</sup> In addition, certain situations covered by the relevant legislation fall outside the scope of the Arbitration Convention.

The Belgium government put forward the justification on the ground of the need to ensure a balanced allocation of the power to tax between Member States and the prevention of tax avoidance.

As regards the need to ensure a balanced allocation of the power to tax between Member States. The Court held that such a justification might be accepted where the system in question is designed to prevent conduct capable of jeopardizing a Member State to exercise its tax rights in relation to activities carried out in its territory.<sup>75</sup> In this case, to permit resident companies to transfer their profit in the form of unusual or gratuitous advantages may undermine the balanced allocation of the power to tax between Member States. By enabling Belgium to include these advantages in the tax base of the resident company granting the advantages, and to tax

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<sup>72</sup> SGI, para. 48

<sup>73</sup> *ibid*, para. 52

<sup>74</sup> *ibid*, para. 54

<sup>75</sup> *ibid*, para. 60



them accordingly, the relevant legislation permitted Belgium to exercise its taxing jurisdiction in respect of activities carried out in its territory.

As regards the prevention of tax avoidance, national legislation which is not specifically aiming at preventing wholly artificial arrangements may nevertheless be regarded as justified by the objective of preventing tax avoidance, taken together with that of preserving the balanced allocation of the power to impose taxes between Member States.<sup>76</sup>

And it pointed out that permitting resident companies to grant unusual or gratuitous advantages to related companies which are resident in other Member States, without applying any corrective tax measure, would bear the risk that by means of artificial arrangements income would be shifted to companies established in Member States applying the lowest tax rate or established in Member States which do not tax such income.

The legislation concerned was also held to be proportionate to the objectives pursued, as the taxpayer had the opportunity, without undue administrative constraints, to provide evidence of commercial justifications and could challenge the tax authorities' assessment before national courts. In addition, only the "non-arm's length" part of the advantages concerned was included in the tax base of the resident company that granted them.

Remark: The legislation in the proceeding provides that, in the internal circumstance, the unusual or gratuitous benefit will be added to the profit of the benefit granting company only if the benefit is not included in the taxable profit of the recipient company. In contrast, in the cross-border situation, the benefit will be added to the profit of the former company no matter whether the benefit will be taxed at the level of foreign recipient company or not. Such a different treatment resulting from transfer pricing rules leads to economic double taxation, which constitutes a restriction on the freedoms of movement. The restriction may be justified by taking together the need to ensure the balanced allocation of tax power between Member States and the prevention of tax avoidance, because, such rules are capable to prevent the profits shift by artificial arrangement and recapture the tax which shall normally paid in a Member State.

### **C-318/10 SIAT<sup>77</sup>**

#### Legal background and facts

According to Belgian law, the 'general rule' provided that companies expenditure shall be regarded as deductible business expenses if it is

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<sup>76</sup> SGI, para. 66

<sup>77</sup> C-318/10 SIAT ECLI:EU:C:2012:415 [Hereinafter "SIAT"]

necessary for acquiring or retaining taxable income and if the taxpayer can demonstrate the authenticity and amount of that expenditure.<sup>78</sup>

At the same time, according to a ‘special rule’, payments for supplies or services made by Belgian taxpayers to taxpayers established in other Member States shall not be regarded as deductible business expenses, where the latter are not subject to tax on income or are subject to a tax regime which is appreciably more advantageous tax regime than the applicable regime in Belgium.<sup>79</sup> The denial of deduction can be refuted by the taxpayer only if he can prove that such payments relate to a genuine and proper transaction and do not exceed the reasonable limits.<sup>80</sup>

#### Restriction and justification

The Court firstly stated that the substantive criteria applied under general rule and the special rule were not same as regards the deduction of business expenses. Under the general rule, there was a presumption that the cost was necessary for acquiring or retaining taxable income. By contrast, under the special rule, the expenditure was presumed non-deductible and can only be deducted by the taxpayer if first of all, he proved that it relates to genuine and proper transactions.

Furthermore, the more advantageous tax regime under the special rule was not defined in the Belgian law, and the special rule was applied by the tax authorities and national courts on a case-by-case basis. This lack of precise delimitation of the scope of the rule created uncertainty as to whether the special rule would apply to a taxpayer.

Accordingly, due to the stricter conditions for the expenditure to be deductible than those of the general rule and the uncertainty created by the lack of a precise delimitation of its scope, the special rule dissuaded taxpayers from exercising their right to make use of services offered by providers established in other Member States, as well as those foreign providers to offer their services to recipients in Belgium.<sup>81</sup> It follows that the Belgian rule constituted a restriction on the freedom to provide and acquire services.

The Belgian Government argued that such restriction can be justified by the need to combat tax avoidance, by the need to preserve the balanced allocation of tax power between Member States and by the need to ensure the effectiveness of fiscal supervision.

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<sup>78</sup> SIAT, para. 4

<sup>79</sup> *ibid*, para. 6

<sup>80</sup> *ibid*

<sup>81</sup> *ibid*, para. 28

The Court accepted these three justifications but held that the rule went beyond what is necessary. The rule required the Belgian taxpayer to provide proof of these services to be genuine and proper, without the tax authorities being required to provide even prima facie evidence of tax evasion or avoidance.<sup>82</sup> The rule also lacked an objective criterion to test for the existence of a wholly artificial arrangement. This lack of predefined scope created a degree of uncertainty. According to the Court, such a rule did not, therefore, meet the requirements of the principle of legal certainty, which requires rules of law to be clear, precise and predictable, in particular, if these effects are unfavourable for taxpayers. Hence, the ECJ concluded that the rule cannot be considered to be proportionate to the objectives pursued.

The Belgian provision was, therefore, an unjustifiable restriction of the freedom to provide services.

Remark: the national rules go beyond what is necessary if it does not meet the requirements of legal certainty. Thus, national transfer pricing rules shall be clear, precise and predictable.

### **Conclusion**

The Court of Justice is more welcome to accept the justifications on discriminatory transfer pricing rules provided that these rules are capable of preventing the profits shift by artificial arrangement and recapture the tax which shall be normally paid in a Member State. However, due to the “single country approach” taken by the Court, it does not take whether there will be any corresponding adjustment in the other Member States concerned into consideration. As a consequence, taxpayers are still exposed to the economic double taxation resulting from transfer pricing rules.

### **3.3.2.3 Exemption and credit method**

Same to the decisions of thin cap rules, the Court also held that in respect of dividend payment, if a Member State employs a system to avoid economic double taxation on domestic dividends, it must achieve the same result on dividends from other Member States. But Member States can choose to apply an exemption method to domestic dividends and a credit method to foreign dividends. However, there may have adverse consequence stemming from to the application of these two approaches.

### **C-446/04 FII Group Litigation (I)<sup>83</sup>**

According to the UK rules at issue, a resident shareholder who receives dividends from a resident company is exempt from corporation tax. By contrast, a shareholder is subject to corporation tax on dividend income if

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<sup>82</sup> SIAT, para. 55

<sup>83</sup> C-446/04 Test Claimants in the FII Group Litigation ECLI:EU:C:2006:774 [hereinafter “FII(I)”]

the dividend is from a non-resident company. But in the latter case, the shareholder is entitled to a credit for the WHT paid in the source state. And when the resident shareholder holds, directly or indirectly, 10% or more of the voting rights in the company making the distribution, the shareholder is entitled to a credit for both WHT and corporation tax paid by the company making the distribution. The UK national courts requested a preliminary ruling on the compatibility of the national rules from the Court.

First, as regards the difference in treatment between dividends received in the context of a 10% or more shareholding from domestic or foreign subsidiaries (freedom of establishment and free movement of capital), the Court held that no matter what mechanism employed for preventing or mitigating the imposition of a series of charges to tax or economic double taxation, the freedoms of movement guaranteed by the Treaty preclude a Member State from treating foreign-sourced dividends less favorably than national-sourced dividends.<sup>84</sup> However, Member States are free to choose the method for mitigating a series of charges to tax. The Parent-Subsidiary Directive leaves open the choice between an exemption and an imputation system. As long as the tax rate applied to foreign-sourced dividends is not higher than the rate applied to national-sourced dividends and that tax credit is at least equal to the amount paid in the Member State of the company making the distribution, up to the limit of the tax charged in the Member State of the company receiving the dividends.<sup>85</sup> There was no less favorable treatment here. Thus, the UK rules were not restrictive in this respect.

Second, as regards dividends paid in the context of a shareholding not exceeding 10% (the free movement of capital), the Court found that there was a different treatment. Under the UK legislation, national-sourced dividends were exempt from corporation tax, whilst foreign-sourced dividends were subject to that tax and were entitled to relief only as regards the WHT charged in the source state.<sup>86</sup> In the context of a tax rule which sought to prevent or mitigate taxation of profits distributed, foreign-sourced and national-sourced dividends are deemed to be comparable as they are both exposed to a series of charges of tax.<sup>87</sup> The recipients of foreign-sourced dividends were in a less favorable situation as they only received credit for the foreign WHT but not for the series of charges of tax existing first, at the distributing company level and, again, in the hands of the shareholder. The ECJ rejected the argument that it would be administratively difficult to determine the tax actually paid in another Member State. It also rejected the claim that the provision of the UK legislation was still more generous than the Parent-Subsidiary Directive. The Court held that although indeed this Directive did not apply, at the

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<sup>84</sup> FII(I), para. 46

<sup>85</sup> *ibid*, para. 57

<sup>86</sup> *ibid*, para. 61

<sup>87</sup> *ibid*, para. 62

material time, to shareholdings under 25%, that did not entail that Member States could maintain legislation that treated foreign-sourced dividends unfavourably under this threshold.<sup>88</sup>

Remark: the rule that applies the exemption method to national-sourced dividends and credit method to foreign-sourced dividends is allowed if (1)the tax rate applied to foreign-sourced dividends is not higher than the rate applied to national-sourced dividends, (2)company receiving the dividends shall be granted a tax credit for the tax actually paid by the company making the distribution in the State in which the latter is resident, and (3)the tax credit is at least equal to the amount paid in the Member State of the company making the distribution, up to the limit of the tax charged in the Member State of the company receiving the dividends.

### **C-35/11 FII Group Litigation(II)**<sup>89</sup>

The objective of this case is to obtain a clarification of the judgment of C-446/04 Test Claimants in the FII Group Litigation.

In the first FII case, the CJEU has already ruled out that exemption method to national-sourced dividends and credit method to foreign-sourced dividends is not contrary to freedom of movements, provided that the tax rate applied to foreign-sourced dividends is not higher than the rate applied to national-sourced dividends and that the tax credit is at least equal to the amount paid in the Member State of the company making the distribution, up to the limit of the tax charged in the Member State of the company receiving the dividends.<sup>90</sup>

In this case, the question arose because the effective level of taxation of the profits of companies resident in the United Kingdom was, in the majority of cases, lower than the nominal rate of tax applicable. For example, imagining the nominal corporation tax rates on resident companies in both the UK and other Member States are 20%. Nonetheless, companies distributing dividends benefit from a corporation tax reduction and therefore the effective tax rate applied is 10% in these Member States. As a result, in the UK, the tax rate that national-sourced dividends subject is 10% due to the exemption method applied, while the tax rate that foreign-sourced dividends subject is still 20% because the imputation method does not enable the tax reductions to be passed on to the shareholder. Then the exemption and imputation methods may cease to be equivalent. And in the UK, in the majority of case, the effective tax rate was lower than the nominal rate. The foreign-sourced dividends were in fact suffered a less favorable treatment than the national-sourced dividends, which constituted a restriction on the freedoms of establishment and capital movements.

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<sup>88</sup> FII(I), para. 67

<sup>89</sup> C-35/11 Test Claimants in the FII Group Litigation ECLI:EU:C:2012:707 [hereinafter “FII(II)”]

<sup>90</sup> FII(II), para. 39

The Court rejected that such restriction can be justified by the need to ensure the cohesion of tax system and held that national rules which took account in particular, also under the imputation method, of the nominal rate of tax to which the profits underlying the dividends paid have been subjected would be appropriate for preventing the economic double taxation of the distributed profits and for ensuring the cohesion of the tax system while being less prejudicial to the freedom of establishment and the free movement of capital.<sup>91</sup>

Remark: when the effective level of taxation of company profits in the Member State concerned is generally lower than the prescribed nominal rate of tax and when the Member State applies the exemption method to the internal dividend but credit method to the foreign dividend, the nominal rate of tax in the dividend distributing Member State shall be taken into account.

**Conclusion:** Following the case-law, the Court of Justice does not oblige Member States to eliminate economic double taxation as a general rule. It only precludes the discriminatory national rules which cannot be justified by overriding public reasons, especially the need to ensure the allocation of tax power between Member States and the prevention of tax evasion. To preclude less-favourable treatment on cross-border activity, where Member States adopt rules to eliminate domestic economic double taxation, such rules should treat the international economic double taxation in the same way.

## 3.4 Problem raised by the ATAD

### 3.4.1 Introduction

The OECD has launched the Anti-Base Erosion and Profit Shifting project, aiming to combat cross-border tax avoidance arrangements as they seriously erode national corporate tax bases and affect the functioning of the internal market. In order to ensure the BEPS measures will be implemented in the EU in a coordinated manner, the Council adopted the Anti-Tax Avoidance Directive on 12 July 2016. The ATAD contains five measures to against tax planning (the interest limitation rule, the exit taxation, the general anti-abuse rule, the controlled foreign company rule, and the hybrid mismatches). The ATAD applies to all taxpayers that are subject to corporate tax in one or more Member States, including PEs in one or more Member States of entities resident for tax purposes in a third country.<sup>92</sup> It sets minimum requirements that Member States need to apply and does not preclude the Member States to adopt a higher level protection for domestic corporate tax bases.

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<sup>91</sup> FII(II), para. 63

<sup>92</sup> ATAD, article 1

### 3.4.2 Interest limitation rule

The interest limitation, which is the article 4 of the ATAD, provides that exceeding borrowing costs are only deductible up to 30% of the taxpayer's earnings before interest, tax, depreciation, and amortization (EBITDA). The "exceeding borrowing cost" means that the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives according to national law.<sup>93</sup> The Member State can introduce carve-out for standalone entities, for the exceeding borrowing cost not exceeding 3 million EUR, for companies belonging to a consolidated group, for financial undertakings and for public project funding. Although Member States may provide carry-forward or carry-back of exceeding borrowing costs and/or unused interest capacity, there is no obligation for Member State to do so. If the interest received state includes the non-deductible exceeding borrowing costs into taxable income, there will be economic double taxation. In recital 5 of the ATAD, the requirement of eliminating double taxation has been shown:

*"Where the application of those rules gives rise to double taxation, taxpayers should receive relief through a deduction for the tax paid in another Member State or third country, as the case may be. Thus, the rules should not only aim to counter tax avoidance practices but also avoid creating other obstacles to the market, such as double taxation."*<sup>94</sup>

However, there is no provision in the ATAD about how to resolve the double taxation arising from the interest limitation rule.

### 3.4.3 Exit taxation

The ATAD introduces an exit tax on transferred assets when assets or businesses are transferred between a head office and a PE or between PEs in different Member States. An exit tax may also arise when a taxpayer transfers its tax residence to another Member State. Taxpayers can defer the payment for five years in some circumstances.<sup>95</sup> The deferral may be subject to interest charging in accordance with the legislation of the relevant Member State and a guarantee may need to be provided for the deferral if there is a demonstrable and actual risk of non-recovery.<sup>96</sup> The recipient Member State shall accept the value established by the exit Member State as the starting point of the assets provided that it reflects market value. Nonetheless, the ATAD provides no solution when the two Member States concerned have different rulings on the market value, or when the value set by the exit

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<sup>93</sup> ATAD, article 2(2)

<sup>94</sup> *ibid*, Recital 5

<sup>95</sup> *ibid*, article 5(2)

<sup>96</sup> *ibid*, article 5(3)

Member State is higher than the market value. In that sense, once the recipient Member State rejects to regard the value set by the exit Member State as the starting value, double taxation may arise.

### **3.4.4 GAAR**

The GAAR is designed to take over the prevention of tax-avoidance agreements where the special anti-avoidance rules do not work. The GAAR provides that “for the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances.”<sup>97</sup> The arrangements shall be regarded as non-genuine to the extent that it is not put into place for valid commercial reasons which reflect economic reality.<sup>98</sup> And the legal consequence of ignoring arrangements is that the corporate tax liability shall be calculated in accordance with national law.<sup>99</sup>

There are some issues regarding the GAAR. Firstly, the terms established the GAAR are relatively new and broad. It leaves questions about how the Member States will implement the GAAR into their national law.<sup>100</sup> For example, “Which commercial reason is valid? What is economic reality? How to determine the purpose of the applicable tax law?”

Although it is stated in the proposal to the ATAD that the GAAR shall be in line with the ECJ’s “artificiality test” when being applied within the EU, there continues to be uncertainty as regards the actual position of the ECJ with respect to different concrete situations.

Since there may have disparities when Member States interpret the GAAR into their national legal system and since there is no mechanism of mutual recognition or corresponding adjustment, the GAAR may lead to double taxation.<sup>101</sup>

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<sup>97</sup> ATAD, article 6(1)

<sup>98</sup> *ibid*, article 6(2)

<sup>99</sup> *ibid*, article 6(3)

<sup>100</sup> Kluwer International Tax Blog, ‘Uncertainties Following the Final EU Anti-Tax Avoidance Directive’, October 17, 2016, available at <http://kluwertaxblog.com/2016/10/17/uncertainties-following-final-eu-anti-tax-avoidance-directive/>

<sup>101</sup> *ibid*



### 3.4.5 CFC rule

The CFC rules have the effect that the income of a low-tax controlled subsidiary would be reattributed to its parent company and then the income would be subject to taxation in the state of the parent company.<sup>102</sup>

An entity or PE would be treated as a CFC where (a) the entity or PE is controlled by a parent company established in the EU and (b) the actual corporate tax it paid on its profit is lower than the difference between the tax that the entity or the PE would pay if it is established in the Member State of the parent company and the actual corporate tax paid.<sup>103</sup>

Once an entity or PE is treated as a CFC, its profit would be included in the tax base of its parent company. The ATAD provides two approaches that Member States may opt for determining the CFC income. Category approach provides a list of income that would be attributed to the tax base of the parent company, for example, royalty, interest and dividend.<sup>104</sup> To comply with the fundamental freedoms, the category approach shall not apply “where the CFC carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances.”<sup>105</sup> Substance approach provides that the Member State of the parent company shall include the non-distributed income of the entity or PE into tax base when the income arises from “non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.”<sup>106</sup> Arrangements shall be regarded as non-genuine to the extent that the entity or PE would not “own the assets or would not have undertaken the risks which generate all, or part of, its income if it was not controlled by a company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income”.<sup>107</sup>

The BEPS report on action 3 listed some situations that double taxation may arise: (i) situations where the CFC income is subject to taxation in the CFC jurisdiction as well as to CFC taxation in the parent company's jurisdiction; (ii) situations where the CFC income is taxed under the CFC rules operating in more than one jurisdiction; (iii) situations where a CFC actually makes dividend distributions out of income that has already been attributed to its shareholders under the CFC rules or where a shareholder disposes of its CFC shares that have previously been included in the tax base pursuant to

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<sup>102</sup> ATAD, Recital 12

<sup>103</sup> *ibid*, article 7(1)

<sup>104</sup> *ibid*, article 7(2)(a)

<sup>105</sup> *ibid*

<sup>106</sup> *ibid*, article 2(b)

<sup>107</sup> *ibid*

CFC rule.<sup>108</sup> Even more complex, double taxation could arise where there is a transfer pricing adjustment between two jurisdictions while a CFC charge arises in a third jurisdiction.<sup>109</sup>

The ATAD provides measures to eliminate double taxation in the situations (i) and (iii). According to Article 8 of the ATAD, the resolution to the double taxation in situation (i) is that the Member State of the parent company shall allow a deduction of the tax paid by the entity or PE in the state in which it resides from the parent company's tax liability.<sup>110</sup>

The resolution to the situation (iii) is that where the entity distributes profits to the taxpayer, the amounts of income previously included in the tax base shall be deducted from the tax base and where the taxpayer disposes of its participation in the entity or PE, and any part of the proceeds from the disposal previously has been included in the tax base pursuant to the CFC rules, that amount shall be deducted from the tax base when calculating the amount of tax due on those proceeds.<sup>111</sup>

Since all Member States are expected to implement CFC rules into their legislation, the risk of the same income subject to simultaneous CFC taxation in two or multiple jurisdictions will most likely increase.<sup>112</sup> Thus, there would be a risk of double taxation if Member States ignore the possibility of multiple CFC taxation when they implement the CFC rules.<sup>113</sup>

### **3.4.6 Hybrid mismatches**

Hybrid mismatches result from the differences in the characterization of payments on financial instruments or of entities under the tax systems of two jurisdictions.<sup>114</sup> Hybrid mismatches can lead to the problem of both double taxation and double non-taxation. For example, a company in State A receives money from other company in State B. The payment is classified as interest in State A while it is treated as dividend in State B. The inconsistent classification may lead to the non-deduction of the payment in the State B, while the payment may still be classified as interest payment in State A and thus included in the taxable of income. This leads to double taxation by way of non-deduction combined with inclusion at the level of the recipient.

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<sup>108</sup> OECD/G20 Base Erosion and Profit Shifting Project, Designing Effective Controlled Foreign Company rules, Action 3: 2015 Final Report, p.65

<sup>109</sup> *ibid*

<sup>110</sup> ATAD, article 8(7)

<sup>111</sup> *ibid*, article 8(5), 8(6)

<sup>112</sup> (n.100)

<sup>113</sup> *ibid*

<sup>114</sup> Helminen M., "EU Tax Law - Direct Taxation", Online Books IBFD,IBFD, 2016 , section: 3.4.7

Double non-taxation occurs when the payment is classified as interest payment in State B, while as dividend payment in State A. The payment may be deductible from the taxable income in State B and not included in the taxable income in State A.

The ATAD only provides approaches to combat double non-taxation. Pursuant to the Article 9 of the ATAD, where a hybrid mismatch leads to double deduction, the deduction shall be given only in the Member State where such payment has its source. For a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.<sup>115</sup> However, the ATAD does not provide any solution to avoid double taxation in respect of hybrid mismatches. Thus, there is a risk of double taxation to taxpayers.

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<sup>115</sup> ATAD, article 9

# 4. Existing mechanism to resolve double taxation disputes

## 4.1 National legal remedies

A taxpayer may challenge the imposition of tax under national legal remedies. However, the national legal remedies are generally not effective when dealing with double taxation because the domestic courts do not have the power to rule on the tax imposed in another jurisdiction.<sup>116</sup> Therefore, other mechanisms have been developed to resolve this issue.

## 4.2 Mutual agreement procedure in the tax treaties

Most double tax agreements include a provision equal or similar to Article 25 of the OECD MTC for a mutual agreement procedure:

*“Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident... The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention.”<sup>117</sup>*

However, the result of the Article 25 is not efficient due to the lack of specified time limit and the time-intensive nature of the process.<sup>118</sup> Also, it does not include enforceable requirements for Contracting States to eliminate double taxation, as the MAP only obliges competent authorities to negotiate, but not requires to reach a solution.<sup>119</sup> Moreover, as the OCED

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<sup>116</sup> Initial Discussion Draft, Opinion Statement FC 4/2017 on the proposed Directive on Double Taxation Dispute Resolution Mechanisms in the European Union, Prepared by the CFE Fiscal Committee Submitted to the European Institutions in [April 2017] available at <http://www.cfe-eutax.org/sites/default/files/5.1.5%20Draft%20CFE%20Opinion%20Statement%20Dispute%20Resolution.pdf>

<sup>117</sup> OECD, Model Tax Convention on Income and Capital 2014, Article 25

<sup>118</sup> The European Commission’s proposal for double taxation dispute resolution, turning the tide

<sup>119</sup> *ibid*

MTC is designed to target the problems incurred by juridical double taxation, the economic double taxation may prevent from entering into the MAP.

## **4.3 The EU Arbitration Convention**

The EU Member States have concluded a multilateral convention which aims to eliminate double taxation in the case of international transfer pricing adjustments of associated enterprises. The Arbitration Convention requires that agreement shall be achieved by Member States to have double taxation eliminated. It provides that if the competent authorities cannot reach an agreement in the MAP, then the case shall be referred to a so-called advisory commission. Concerning the legal status, the Arbitration Convention is not part of EU law as it is a multilateral convention concluded among the Member States. Thus, the EU Courts have no power to interpret the Arbitration Convention.

The Convention covers both double taxation of two group companies of two different EU Member States and double taxation of the headquarters and a branch in a different Member State.<sup>120</sup> Thus, it applies to both international juridical and international economic double taxation.

### **4.3.1 The function of the Arbitration Convention**

#### **(1) Mutual agreement procedure**

Where an enterprise considers that the arm's length principle has not been observed, it may irrespective of the national remedies provided by the Contracting State concerned, present its case to the competent authority of the Contracting State.<sup>121</sup> The enterprise shall at the same time notify the competent authority if there are other Contracting States that may be involved in the case.<sup>122</sup> The competent authority shall then without delay notify the competent authorities of those other Contracting States.

If the competent authority considers the complaint is well-founded and a satisfactory solution is not able to be achieved by itself, the competent authority shall endeavour to resolve the case by mutual agreement with any other competent authority concerned, with a view to having the double taxation eliminated on the base of arm's length principle.<sup>123</sup> The competent

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<sup>120</sup> Helminen M., "EU Tax Law - Direct Taxation", Online Books IBFD, IBFD, 2016, section: 5.4.2.1

<sup>121</sup> Arbitration Convention, article 6(1)

<sup>122</sup> *ibid*, article 6(2)

<sup>123</sup> Helminen M., "EU Tax Law - Direct Taxation", Online Books IBFD,IBFD, 2016, section: 5.4.5.3

authorities should endeavour to reach an agreement within 2 years of the date on which the case was first submitted to one of the competent authorities. However, there is no obligation under the MAP for Member States to reach an agreement to eliminate double taxation.<sup>124</sup> Once the Contracting States reached an agreement, the agreement should be implemented irrespective of any time limits prescribed by the domestic legislation of the Contracting States concerned.<sup>125</sup>

## **(2) Arbitration procedure**

Article 7 provides that if the competent authorities concerned fail to reach an agreement within two years, they shall set up an advisory commission charged with delivering its opinion on the elimination of the double taxation in question.<sup>126</sup> However, once the case has been submitted to a court or tribunal, the term of two years referred to shall be computed from the date on which the judgment of the final court of appeal was given.<sup>127</sup> Where a Member State's domestic law does not permit its competent authorities to derogate from the decisions of its judicial bodies, the advisory commission will not be set up unless the associated enterprise of that State has allowed the time provided for appeal to expire, or has withdrawn its appeal before a decision has been delivered.<sup>128</sup>

The advisory commission shall deliver its opinion not more than 6 months from the date on which the matter was referred to it and the opinion of the advisory commission must be based on the arm's length principle.<sup>129</sup> The competent authorities party to the procedure must take a decision which will eliminate the double taxation within 6 months from the date on which the advisory commission delivered its opinion.<sup>130</sup> The competent authorities must take the decision acting by common consent and the decision must be based on the arm's length principle.<sup>131</sup> The decision may be in line with the opinion of the advisory commission or it may deviate from it provided that it is based on the arm's length principle and it eliminates the double

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<sup>124</sup> Helminen M., "EU Tax Law - Direct Taxation", Online Books IBFD,IBFD, 2016, section: 5.4.5.3

<sup>125</sup> Arbitration Convention, article 6(2)

<sup>126</sup> *ibid*, article 7(1)

<sup>127</sup> *ibid*, article 7(1)

<sup>128</sup> *ibid*, article 7(3)

<sup>129</sup> *ibid*, article 11(1)

<sup>130</sup> *ibid*, article 12 (1)

<sup>131</sup> *ibid*

taxation.<sup>132</sup> If the competent authorities cannot reach an agreement, they are obliged to act in accordance with the opinion of the advisory commission.<sup>133</sup>

### **4.3.2 The shortcomings of the Arbitration Convention**

The Arbitration Convention has been criticized a lot for its insufficiencies. In the following, the shortcomings of the Arbitration Convention will be given.

#### **(1) Limitation of scope**

The Arbitration Convention only applies to double taxation caused by international transfer pricing adjustments. Therefore, it cannot be used as a basis for other fields of double taxation.

#### **(2) Lack of supervisor mechanisms**

There is no supervisor organ under the Convention that registers and monitors case regarding their progress and whether or not the Convention's deadlines are being complied with by competent authorities, and which can take action if competent authorities fail to fulfill their obligation under the Convention.<sup>134</sup> Although national courts are generally competent to enforce compliance with obligations arising under the Convention if competent authorities fail to fulfill them, it has been acknowledged as not an efficient option, as it always delays the process of eliminating double taxation.<sup>135</sup> Thus, without a supervisory organ, there is no guarantee that double taxation will be eliminated in the given timeframe.

#### **(3) Missing timeline**

The Convention provides a timeline for the MAP (two years), the arbitration procedure (six months) and the final decision from competent authority (six months). However, it does not define a timeline for the process before the mutual agreement procedure. Therefore, there is no limit for the competent authority to make a decision on whether the case is well-founded and whether the competent authority is not able to arrive at a satisfactory solution by itself.<sup>136</sup> This leaves Member States quite some leeway in conducting this

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<sup>132</sup> Arbitration Convention, article 12(1)

<sup>133</sup> H.M. Pit, 'Commission Initiative To Improve Dispute Settlement Mechanisms within the European Union - The EU Arbitration Convention (90/436)' (2016) European Taxation, November 2016, p.514

<sup>134</sup> *ibid*

<sup>135</sup> *ibid*

<sup>136</sup> *ibid*, p.515

procedure.<sup>137</sup> Moreover, the starting point of the MAP differs significantly. According to the Commission researches, some of the Member States hold that the two-year period does not start until the other Member State has formally notified that it does not accept the adjustment, while some other Member States express it starts when the tax authority receives a request from the taxpayer or when all necessary information has been provided.<sup>138</sup> As a consequence, it is uncertain for the taxpayers as to if and when their cases will be resolved.

#### **(4) The absence of definition of terms**

Many terms are not defined in the Convention, such as “enterprises” in Article 1(1), “well-founded” and “satisfactory solution” in Article 6(2), and “serious penalty” in Article 8, which all give pressing influence in the application of the Arbitration Convention. Although according to Article 3(2), “[a]ny term not defined in this Convention shall, unless the context otherwise requires, have the meaning which it has under the double taxation convention between the States concerned,” this provision does not resolve many interpretation problems. It does not provide a solution when there is no double taxation convention between Member States or when more than two States are concerned.<sup>139</sup> Moreover, some of the conventions do not contain many definitions, but referring to national legislation for interpretation.<sup>140</sup> Thus, there may be different applications according to the Member States concerned. Unlike the instruments of the EU, the CJEU does not have right to interpret the terms of the Convention. Therefore, there is no solution to the different application of the Arbitration Convention. As a result, Member States can find easy excuses to refuse the application.

#### **(5) Unsatisfactory interaction with available domestic remedies**

According to Article 6(1), “[w]here an enterprise considers that...the principles set out in Article 4 have not been observed, it may, irrespective of the remedies provided by the domestic law of the Contracting States concerned, present its case to the competent authority...”, this article implies that the Convention’s procedures and national legal remedies run simultaneously. Such simultaneous application aims to ensure that nothing blocks the taxpayers’ access to the elimination of double taxation.<sup>141</sup>

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<sup>137</sup> (n.133), p.515

<sup>138</sup> Commission Staff Working Paper Company Taxation in the Internal Market, COM (2001) 582 final, p.281

<sup>139</sup> Dirk Schelpe, ‘The Arbitration Convention: Its Origin, Its Opportunities and Its weaknesses’ EC Tax Review, 1995/2, 68-77, p.72

<sup>140</sup> *ibid*

<sup>141</sup> H.M. Pit, ‘Commission Initiative To Improve Dispute Settlement Mechanisms within the European Union - The EU Arbitration Convention (90/436)’ (2016) European Taxation, November 2016, p.517



Therefore, once the competent authority rejects the taxpayer access to the procedures of the Convention, the taxpayer may lodge a domestic appeal for the elimination of double taxation unilaterally. Similarly, when the national courts agree on the adjustment of profit imposed, the taxpayer still has the possibility to have the double taxation eliminated by the Arbitration Convention.

Nonetheless, in practice, such parallel functioning has effectively blocked by Article 7(1) and 7(3) of the Convention. Article 7(1) provides that where the enterprises have recourse to the remedies available to them under the domestic law and where the case has so been submitted to a court or tribunal, the two-year period of the MAP starts from the date on which the judgment of the final court of appeal was given. Therefore, the competent authorities will not likely commence their proceedings under the MAP while domestic procedures are pending.<sup>142</sup> Moreover, in accordance with Article 7(3), where a national law of a Member State does not permit the competent authorities of the State to derogate from the decisions of their judicial bodies, the arbitration procedure shall not apply if a decision has been delivered by the national courts. As a consequence, taxpayers are no longer granted a right to have double taxation eliminated under the Convention in the event a judicial body has already given a decision in the case, even if this decision does not resolve the double taxation.<sup>143</sup>

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<sup>142</sup> (n.141), p.517

<sup>143</sup> *ibid*, p.518

# 5. Proposed Directive on Double Taxation Dispute Resolution

After recognizing the shortcomings of the existing double taxation resolution mechanism, the European Commission proposed a directive to improve the present mechanism, which is expected to be transposed into national law of Member States by 31 December 2017. Once it has been entered into force, all national branches are bound by it.

## 5.1 The scope of the Proposed Directive

The Proposed Directive applies to all taxpayers that are subject to one of the taxes on income from business listed in Annex I of the Proposed Directive, including PEs situated in one or more Member States whose head office is either in a Member State or a jurisdiction outside the Union.<sup>144</sup> Annex I provides that the taxes referred include income tax and corporation tax, which implies that both physical and legal persons are covered.

The Proposed Directive applies to disputes between Member States. Consequently, while the PEs of taxpayers which are located outside the European Union may be involved in the dispute resolution process, taxation by foreign jurisdiction in itself would not fall within the scope of the directive.<sup>145</sup>

The Proposed Directive “does not apply to any income or capital within the scope of a tax exemption or which a zero tax rate applies under national rules.”<sup>146</sup>

## 5.2 The function of the Proposed Directive

The Proposed Directive provides a three-step dispute resolution mechanism:

### **(1) The complaint stage**

Article 3(1) of the Proposed Directive provides that “any taxpayer subject to double taxation shall be entitled to submit a complaint requesting the resolution of the double taxation to each of the competent authorities of the Member States concerned within three years from the receipt of the first notification of the action resulting in double taxation, whether or not it uses the remedies available in the national law of any of the Member States concerned.”<sup>147</sup> The competent authorities shall provide the confirmation of its receipt within one month to both taxpayers and the other competent

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<sup>144</sup> The Proposed Directive, article 1

<sup>145</sup> *ibid*

<sup>146</sup> *ibid*

<sup>147</sup> *ibid*, article 3(1)

authorities involved.<sup>148</sup> The competent authorities shall decide on the acceptance and admissibility of the complaint within six months of the receipt thereof. The decision can either be positive (accept the complaint) or negative (reject the complaint). A negative decision must be capable of being appealed in the domestic courts.

If all the Member States involved adopt positive decisions, then the MAP is initiated. If one of the Member State involved issues a negative decision, an Advisory Commission shall be set up by the competent authorities concerned. The Advisory Commission is liable to deliver a decision on the admissibility and acceptance of the complaint within six months from the date of notification of the last decision rejecting the complaint.<sup>149</sup> If the Advisory Commission confirms the existence of double taxation, the competent authorities concerned can request to start the MAP. Otherwise, the Advisory Commission shall give a decision on the elimination of double taxation.<sup>150</sup> If all the Member States involved decide to reject the complaint, then the procedure under the Proposed Directive ends.

## **(2) Mutual agreement procedure**

Under the MAP, the Member States concerned shall endeavor to resolve the double taxation within 2 years, starting from the last notification of the decision of one of the Member States to accept the complaint.<sup>151</sup> The MAP would end up in two situations. First, if the Member States concerned end up in an agreement on the elimination of double taxation, the competent authorities must transmit the agreement to the taxpayer as a decision. The decision is binding on the competent authorities and enforceable by the taxpayer and must be implemented under national law. The domestic legal remedies shall be available to the taxpayer. Second, if the Member States concerned fail to reach an agreement, the arbitration procedure would start, except the double taxation is in cases of tax fraud, willful default, and gross negligence.

## **(3) Arbitration Procedure**

The Advisory Commission shall be set up in the case where a complaint has been rejected by one Member State regarding the acceptance and/or the admissibility of the complaint, which has been reversed by the Advisory Commission, but subsequently to which none of the competent authorities have requested the MAP. It shall also be set up in the case when no agreements has been reached in the MAP stage. The Advisory Commission must be established no later than 50 calendar days after the end of the two-year time limit for the MAP. Moreover, the competent authorities of the Member States concerned may agree to set up an Alternative Dispute Resolution Commission (“ADRC”) instead of the Advisory Commission.

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<sup>148</sup> The Proposed Directive, article 3

<sup>149</sup> *ibid*, article 6(2)

<sup>150</sup> *ibid*, article 6(1)

<sup>151</sup> *ibid*, article 4(1)

The ADRC may differ regarding its composition and form from the Advisory Commission and apply conciliation, mediation, expertise, adjudication or any other dispute resolution process or techniques to solve the dispute.<sup>152</sup> The ADRC or the Advisory Commission shall deliver its opinion no later than 6 months after the date it was set up to competent authorities of the Member States concerned.<sup>153</sup> After the ADRC or the Advisory Commission has delivered its opinion, the competent authorities shall agree on the opinion of the Advisory Commission or the ADRC within 6 months.<sup>154</sup> The competent authority may take a decision, which deviates from the opinion of the Advisory Commission or the ADRC, but they are bound by that opinion if they fail to reach an agreement to eliminate the double taxation.<sup>155</sup> Member States shall provide that the final decision eliminating double taxation is transmitted by each competent authority to the taxpayers within 30 calendar days of its adoption.<sup>156</sup> That final decision is, subject to the taxpayer renouncing the right to any domestic remedy, binding on the competent authorities and enforceable by the taxpayer, and must be implemented into national law irrespective of any time limits. Taxpayers must also be able to refer to national courts in the case of a failure to implement the decision.

#### **(4) The elimination of double taxation**

In the Proposed Directive, the double taxation can be regarded as eliminated when only one Member State includes the income subject to double taxation in the computation of the taxable income, or when the tax chargeable on this income in one Member State is reduced by an amount equal to the tax chargeable on it in any other Member State.<sup>157</sup>

## **5.3 Analysis**

### **(1) The scope**

The Proposed Directive, at first sight, has a very broad scope. In comparison to the Parent-Subsidiary Directive and the Interest-Royalty Directive, the application of the Proposed Directive does not limit to associated companies having more than 10% or 25% shareholdings. Instead, it applies to both independent parties and dependent parties without any shareholdings requirements. Also, unlike the Arbitration Convention, which only resolves double taxation in respect of transfer pricing adjustments, the Proposed Directive broadens the scope, aiming to eliminate double taxation on business income in all cases.

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<sup>152</sup> The Proposed Directive, article 9(2)

<sup>153</sup> *ibid*, article 13(1)

<sup>154</sup> *ibid*, article 14(1)

<sup>155</sup> *ibid*, article 14(2)

<sup>156</sup> *ibid*, article 14(3)

<sup>157</sup> *ibid*, article 4(2)

It has been argued whether the Proposed Directive covers economic double taxation. This question is raised due to the wordings of Article 3(1), “any taxpayer subject to double taxation shall...”. Accordingly, the entitlement to submit a complaint in requesting the resolution appears to be limited to only same taxpayers subject to tax twice (juridical double taxation).<sup>158</sup> However, this argument cannot be upheld. Under the Explanatory Memorandum, the Proposed Directive builds on the existing Arbitration Convention but broadens its scope to areas which have not been covered.<sup>159</sup> Since the Arbitration Convention applies to both juridical and economic double taxation, the scope of the Proposed Directive shall not be limited to juridical double taxation. Moreover, concerning the objectives of the Proposed Directive, it intends to provide an effective solution for all cases of double taxation on business income.<sup>160</sup> Therefore, the economic double taxation shall not be excluded from the application of the Proposed Directive.

It is expected that the unresolved double taxation concerning interest payment, dividend payment, transfer pricing adjustment shall all come into the scope of the Proposed Directive.

As discussed above, there is a risk of potential double taxation raised by the ATAD. The Arbitration Convention precludes the application of its procedures when the enterprise is liable to a serious penalty. By contrast, the Proposed Directive has a significant improvement by allowing a concurrent application.<sup>161</sup> Under Article 1, “this Directive shall not preclude the application of national legislation or provision of international agreements where it is necessary to prevent tax evasion, tax fraud or abuse.” This provision points out that the Proposed Directive also applies to a dispute involving an anti-abuse provision.

Concerning the multiple taxation, the definition of the double taxation provides that, “double taxation means the imposition of taxes... by two (or) more jurisdictions...”<sup>162</sup>, which indicates that the application of the Proposed Directive shall also cover the multiple situations.

## **(2)The deadline**

To improve the effectiveness, the Proposed Directive introduces a strict and enforceable timeline. The Arbitration Convention was criticized for the missing deadline before the mutual agreement procedure. The Proposed Directive improves this by obliging the competent authorities of the

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<sup>158</sup> Filip Debelva and Joris Luts, ‘The European Commission’s Proposal for Double Taxation Dispute Resolution: Turning the Tide?’, section: 3.2.4.5

<sup>159</sup> The Proposed Directive, Explanatory Memorandum, p.3

<sup>160</sup> Filip Debelva and Joris Luts, ‘The European Commission’s Proposal for Double Taxation Dispute Resolution: Turning the Tide?’, section: 3.2.4.5

<sup>161</sup> Sriram Govind and Laura Turcan, ‘The Changing Contours of Dispute Resolution in the International Tax World: Comparing the OECD Multilateral Instrument and the Proposed EU Arbitration Directive’, (2017), Bulletin for International Taxation, 2017 (Volume 71), No.3/4, section: 3.2

<sup>162</sup> The Proposed Directive, article 2(3)

Member States to decide on the admissibility and acceptance of the complaint of a taxpayer within 6 months of the receipt thereof. And if the complaint is only rejected by one of the competent authorities, the Advisory Commission shall be set up, which shall adopt a decision on the admissibility and acceptance of the complaint within 6 months from the date of notification of the last decision rejecting the complaint. Moreover, the competent authorities shall acknowledge receipt of the complaint with 1 month<sup>163</sup> and may request the information from the taxpayer within two months from the receipt of the complaint.<sup>164</sup> Therefore, there will be identified deadline for the complaint procedure.

The Proposed Directive also provides strict and enforceable timelines for the MAP (2 years, but can be extended by up to 6 months subject to the acceptance by taxpayers and the competent authorities), the setting up of Advisory Commission (50 days), the opinion from Advisory Commission(6 months) and the final decision by the competent authorities(6 months).

### **(3)The interpretation of terms**

There are some terms that have not been defined in the Proposed Directive. For example, “this Directive applies to all taxpayers that are subject to one of the taxes on income from business”<sup>165</sup>, neither the income nor the business has been defined. This may leave questions: what is “income”? What can be regarded as “business”?<sup>166</sup> Thereby it gives uncertainty to the taxpayers concerning whether they can claim the protection under the Proposed Directive.

As opposed to the Arbitration Convention, the terms of which are interpreted by the bilateral agreements or national legislation, the Court of Justice is supposed to give a standard interpretation of the Proposed Directive.<sup>167</sup> The shortcomings of inapplicable of the Arbitration Convention resulting from different interpretation of its terms may be addressed by the uniform interpretation from the Court in the Proposed Directive. Although undefined terms can be resolved by referral process to the CJEU, it will last for a long time and will not be resolved in the short future. In that sense, this would be better to be improved in the official directive.

### **(4)The supervisory mechanism**

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<sup>163</sup> The Proposed Directive, article 3(2)

<sup>164</sup> *ibid*, article 3(4)

<sup>165</sup> *ibid*, article 1

<sup>166</sup> Filip Debelva and Joris Luts, ‘The European Commission’s Proposal for Double Taxation Dispute Resolution: Turning the Tide?’, section: 3.2.4.6

<sup>167</sup> Consolidated Version of the Treaty on the Functioning of the European Union, [2016] OJ C202/47, [hereinafter “TFEU”], article 267

Firstly, it is the task of the Commission to make sure that the Member States implement the Proposed Directive correctly. The Commission is required to initiate an infringement procedure before the Court of Justice if it considers that a Member State has enacted or kept in force domestic provisions, which are incompatible with the EU law, or that it has failed to implement a directive in a timely or accurate fashion.<sup>168</sup> Concerning monitoring cases in terms of their progress and whether or not the Convention's deadlines are being complied with by competent authorities, it is still the task of the national court to do so in the Proposed Directive. As analyzed above, the national court has been criticized in the Arbitration Convention as not an efficient option. The problem still has not been resolved in the Proposed Directive. However it may be resolved by ways, which have been suggested by Pit in his article<sup>169</sup>, "a central and permanent secretariat could be established, functioning under the auspices of the European Commission, which would assist advisory commissions in conducting the arbitration procedure and also monitor compliance with the Convention deadlines."

#### **(5) Interaction with national proceedings**

The provisions concerning the interaction with national proceedings in the Proposed Directive do not make any difference comparing to the Arbitration Convention. Article 15(3) of the Proposed Directive is similar to the Article 7(1) of the Arbitration Convention, which provides that, "where the case has been submitted to a court or tribunal, the following dates shall be added to the date on which the judgment of the final court was given: (a) six months referred to in Article 3(5) concerning taking a decision on the acceptance and admissibility of the complaint; (b) two years referred to in Article 4(1) about the MAP." This provision prevents the Proposed Directive's procedures and national legal remedies to run simultaneously and may extend the time for having double taxation elimination to an unforeseeable length.

The Proposed Directive also provides derogation from the Directive. Where the domestic law of a Member State does not permit that a dispute resolution decision derogates from the decisions of their judicial bodies, the arbitration procedure and the procedure regarding determining of admissibility and acceptance of the complaint by the Advisory Commission shall not be available to the taxpayer once the judicial proceedings concerning the double taxation have been initiated, unless the taxpayer withdrawn its action before the final decision is delivered.<sup>170</sup> Therefore, the

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<sup>168</sup> TFEU, article 258 and article 259, see also, Sriram Govind and Laura Turcan, 'The Changing Contours of Dispute Resolution in the International Tax World: Comparing the OECD Multilateral Instrument and the Proposed EU Arbitration Directive', section 3.1

<sup>169</sup> H.M. Pit, 'Commission Initiative To Improve Dispute Settlement Mechanisms within the European Union - The EU Arbitration Convention (90/436)' (2016) European Taxation, November 2016, p.520

<sup>170</sup> The Proposed Directive, article 15(2)

taxpayers may not be able to have the double taxation eliminated, once the judicial body in a Member State has already given a decision, even if the decision does not resolve the double taxation.



## Conclusion:

Juridical and economic double taxation constitute an obstacle to the functioning of the single market. The European Union has adopted the Parent-Subsidiary Directive and the Interest-Royalty Directive to allocate the power to tax between Member States in respect of dividend, interest, and royalty. Due to the limited scope, the two directives fail to remove the double taxation issues in these three respects and are even far from resolving other issues. The Court of Justice of the European Union regards itself as unable to provide any help for juridical double taxation. Because juridical double taxation as the parallel exercise of Member States' fiscal sovereignty, in the absence of uniform measures at the EU level, the Court has no competent to allocate Member States' power to tax. By contrast, the Court gives preliminary rulings on the economic double taxation issues. Following the case-law, the Court precludes economic double taxation resulting from discriminatory national rules which cannot be justified by overriding reasons. And once a Member State has a system to prevent economic double taxation, it should treat the internal situations and the cross-border situations in the same way. Consequently, taxpayers may still subject to economic double taxation in the case that national rules are not discriminatory. Therefore, the substantive law of the EU is capable of resolving double taxation only in a limited scope. Moreover, the Anti-Tax Avoidance Directive may expose the taxpayers to more potential double taxation issues.

The Arbitration Convention, which is a multilateral convention concluded between Member States, provides a set of procedural rules for Member States to have double taxation eliminated in the field of international transfer pricing adjustments. It has been recognized that the Arbitration Convention fails to achieve the objectives that were supposed to obtain. It has been criticized for having many shortcomings, for example, missing timeline and uninterpreted terms, which prevent the taxpayers to benefit from the Arbitration Convention. For improving the existing measures, the European Commission has proposed a directive which aims to resolve double taxation on business income in all cases. The Proposed Directive is designed to provide a broader scope and a more enforceable mechanism to conquer the shortcomings of the existing approaches. Although the Proposed Directive is capable of providing more protection to taxpayers, there are still some potential risks that may block the taxpayer to access to the Proposed Directive. The undefined terms of the Proposed Directive may lead to 28 versions of interpretation in the EU. Moreover, the lack of supervisory organ and the incomplete interaction with Member State's national legislation may bring the time of procedure into an unforeseeable length. Therefore, although the Proposed Directive is a big step in the improvement of double taxation issue resolution mechanism, it may still be unable to resolve all remaining double taxation issues on business income.

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