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1. Introduction

In spite of the already wide jurisprudence of the EC Court of Justice (ECJ) about non-discrimination of permanent establishments it is not yet clear how far this non-discrimination obligation goes. On the other hand, if it has been reaffirmed that Member States' double taxation conventions are also submitted to the non-discrimination principle, it is not clarified if a most-favoured-nation clause¹ does bind Member States when applying them. After the *Saint-Gobain* case, all attention was concentrated on the *Metallgesellschaft* case but both the Advocate-General and the Court avoided the problem and made no considerations about the existence of a most-favoured-nation clause which at least indicates serious hesitation in taking this step further in the interpretation of EC non-discrimination.

Although a preliminary analysis of the non-discrimination principle may indicate that it requires a broad scope of application, the balancing of the emerging consequences orientates us to quite different results. We bring to this analysis, as the main exemplifying cases, *Saint-Gobain* and the *Metallgesellschaft*.

2. Scope of the EC Treaty non-discrimination principle in respect of permanent establishments: *Saint-Gobain*

2.1 Application of Article 24, section 3 of the OECD Model and the EC Treaty non-discrimination principle to triangular cases: introductory remarks

Let us first concentrate on the scope of non-discrimination in respect of permanent establishments. From the jurisprudence of the ECJ it is quite clear that they should not be discriminated by the Member State of establishment in comparison to subsidiaries. This prohibition of discrimination in-

cludes both internal and treaty rules: the latter are also part of internal law and besides non-discrimination principle could not be dependent on the juridical adopted form.² The fact that a Contracting State (state PE) may not discriminate income of a permanent establishment located in its territory but resident in the other Contracting State, already results from Art. 24, s. 3 of the OECD Model and therefore the EC Treaty non-discrimination principle does not here introduce any novelty (notwithstanding the fact, that the EEJ recognized direct applicability to the EC Treaty non-discrimination principles).

However, as tax benefits attributed by double taxation conventions concluded by a state are only available to residents of one of the two Contracting States, a non-resident permanent establishment with passive investment income in a third state would in principle be precluded from treaty benefits in the source state (state S). Thus, in relation to triangular cases, it is necessary to clarify the scope of non-discrimination both within the OECD Model and the EC Treaty.

¹ See e.g. the research project of the Department of Austrian and International Tax Law at the University of Economics and Business Administration in Vienna on the necessity of concluding a multilateral tax treaty in the EC, published in *Multilateral Tax Treaties, New Developments in International Tax Law* (Kluwer Law International and Linde Verlag, London, The Hague, Boston, 1998): some authors make references to the most-favoured-nation clause.

² See e.g. Michael Lang, 'Die Bindung der Doppelbesteuerungsabkommen an die Grundfreiheiten des EU-Rechts', in (ed. W. Gassner et al.), *Doppelbesteuerungsabkommen und EU-Recht, Auswirkungen auf die Abkommenspraxis* (1996), pp. 27ff; Luc Hinnekens, 'Compatibility of Bilateral Tax Treaties with European Community Law. The Rules', *EC Tax Review* 1994/4, pp. 146ff. See also case 270/83, *European Commission v France Republic*, ECJ 28 January 1986, point 21.

There is no unanimity among OECD Member States in respect of the non-discrimination principle contained in Art. 24 of the OECD Model. Most - but not all - of the Member States consider that the source state should not treat the permanent establishment as a resident in the state of location.³ But, according to the triangular cases report and under the influence of the ECJ jurisprudence, many of them are of the opinion that a permanent establishment may invoke the non-discrimination principle under the treaty between the residence state (state R) and state PE in respect of income resulting from passive investment in a third country.⁴ This interpretation reflects the fact that the ECJ considers double taxation conventions to be covered by the EC non-discrimination principle. As a direct consequence of this interpretation, the discussion of Art. 24 within the OECD has taken into account EC law obligations.

If in respect of the behaviour of the permanent establishment state of location, OECD Member States have expressed the aforementioned point of view, there are many doubts in respect of other questions. For example, the meaning itself of equal treatment of permanent establishments in relation to subsidiaries is not unambiguous in international tax law, namely because distribution of dividends of permanent establishments is not subject to withholding tax, whereas distribution of dividends of a subsidiary may be subject to it.⁵ However, we may add that the scope of non-discrimination is neither explicit in the EC law, nor made clear in the *Saint-Gobain* case.

Although the ECJ considered that Germany could not treat dividends obtained in a third country, attached to a permanent establishment, differently from dividends obtained in a third country, attached to a subsidiary (which were exempted according to a bilateral tax treaty), it is not clarified if the EC Treaty non-discrimination principle demands permanent establishments to be considered residents for the purpose of double taxation conventions. Furthermore, the question whether the decision would be the same in case the profits of the permanent establishment were taxed in the state of residence was left open. Finally, it is also doubtful what would the Court have decided in case state PE did not tax income of permanent establishments in the normal way.

2.2. Must permanent establishments, in triangular cases, be treated as residents under double taxation conventions?

As a rule, the EC Treaty non-discrimination principle is aimed at the source state which may not treat less favourably a permanent establishment than a subsidiary (or a non-resident individual in comparison to a resident individual if they are in a comparable position). If, in most cases, judged by the ECJ involving non-discrimination of permanent establishments, the source state coincides with the permanent establishment Member State, the reality changes when a permanent establishment has passive investment in another state.

In fact, in triangular cases like the *Saint-Gobain*, we

must consider if the scope of non-discrimination does not alter. As already mentioned, the question has been raised in the OECD report on triangular cases and recommendations were given to Member States to clarify the matter in bilateral negotiations.

On the one hand, there is no doubt that the purpose of Art. 24, s. 3 of the OECD Model is that the state where the permanent establishment is located ends all discrimination with respect of permanent establishments as compared with resident enterprises.⁶ Also, until now, the jurisprudence of the ECJ, reaffirmed in the *Saint-Gobain* case, coincides with the proclaimed objectives of the OECD Model. But as was referred to above, we must still consider if the source Member State should not apply its double taxation conventions with the PE Member State and treat the permanent establishment as a resident of the PE state.⁷

If a few OECD Member States consider that on the basis of the PE-S double taxation convention, the permanent establishment should be treated as a resident of the state of location, most of them fear that this interpretation of non-discrimination would act as an incentive to treaty shopping when the residence state exempts the profits of the permanent establishment.⁸ Nonetheless, in the triangular cases OECD report, several possibilities are analyzed, which include application of R-S treaty, R-PE treaty and PE-S treaty. That is, even under Art. 24, s. 3 of the OECD Model, it is admitted that the source and the residence states contribute to eliminate double taxation of the income attached to the permanent establishment.

If this interpretation is valid under the OECD Model, we may not easily conclude that, under Art. 43 of the EC Treaty (in which non-discrimination is connected with free movement of persons), obligations are exclusively destined to the permanent establishment state: if we understand that a permanent establishment should not be differently taxed in relation to subsidiaries, the next step is to induce that it may not be discriminated by any (Contracting) Member State.

If, according to the ECJ, non-discrimination principle means that the 'same' or 'comparable' situations should not be treated differently in one Member

³ *Triangular Cases*, report adopted by the OECD Council on 23 July 1992, R(11)-11, point 39. Cf. Cees Peters and Margreet Snellaars, 'Non-discrimination and Tax Law: Structure and Comparison of the Various Non-discrimination Clauses', *EC Tax Review* 2001/1, p. 14.

⁴ OECD, *Triangular Cases*, R(11)-9, 10.

⁵ OECD Model Tax Convention on Income and Capital, April 2000, Commentary on Art. 24, para. 3, points 23, 31 (19 ff). Cf. the arguments of the German Government, in C-307/97, *Compagnie de Saint-Gobain ZN v Finanzamt Aachen-Innenstadt*, ECJ, 21 September 1999, sections 47 and 50.

⁶ OECD Model Tax Convention on Income and Capital, Commentary on Art. 24, para. 3, point 19.

⁷ See OECD, *Triangular Cases*, R(11)-5, points 11-12, 37-38, 39, 42-46; H.E. Kostense, 'The *Saint-Gobain* Case and the Application of Tax Treaties. Evolution or Revolution?', *EC Tax Review* 2000/4, pp. 225ff.

⁸ See OECD, *Triangular Cases*, point 44.

State,⁹ this judgment is required in any Member State where the problem occurs, i.e. where the situations must previously be compared. It is useful at this point to recall the formula of the ECJ, according to which it is discriminatory to apply different rules to similar situations or to apply the same rule to different situations.¹⁰ In this sense, similar tax treatment does not require harmonization.

Thus, as a rule, in order to verify if the principle of non-discrimination was respected we must observe tax treatment of residents and non-residents in (any) one Member State.¹¹ If we follow this reasoning to its ultimate consequences, then we may ask if in the *Saint-Gobain* case both non-discrimination and freedom of establishment do not demand that the source states may not tax income resulting from a permanent establishment passive investment differently.

2.3. Must the residence state, in triangular cases, contribute to eliminate double taxation?

We may still go a step further. If EC treaty non-discrimination is in general an obligation of the source state, there are situations in which the global tax burden must be considered in order to evaluate the discrimination effect, as it was done in the *Schumacker* and the *Wielockx* cases.¹² Thus, in triangular cases, the tax law regime of the residence state in respect of non-resident permanent establishments may also interfere in the global tax burden.

Moreover, if in triangular cases it is common that the source state applies the residence-source double taxation convention in respect of the income of the permanent establishment situated in another state,¹³ if it is also advocated that under the same R-S double taxation convention, the residence state should eliminate double taxation in respect of source withholding tax;¹⁴ then, this means that within EC Member States, elimination of double taxation must also be guaranteed by the residence state, either the permanent establishment is not covered by the double taxation convention PE-S (and the R-S convention is applicable), or even in case PE-S treaty is applicable.

It is therefore doubtful what the ECJ judgment would have been if in the *Saint-Gobain* case the state of residence applied the credit method instead of the exemption method. If state R adopted the credit method in respect of the permanent establishment income, we should again analyze the case in an overall perspective of total tax burden. Assuming that state S applied R-S treaty in respect of the dividends attached to the permanent establishment, state PE had to credit the source taxation of the dividends (either according to the PE-R treaty or to the PE-S treaty); but if this credit was inferior to source taxation under double tax convention R-S, then state R should compensate the resulting double taxation by giving itself a tax credit. This preliminary analysis indicates that, in the EC perspective, non-discrimination in triangular cases must be assured by the three involved states and presupposes an overall tax burden judgment. The results might be, nevertheless, unexpected.

As a matter of fact, as demonstrated by Kostense, a

'revolutionary interpretation' of the *Saint-Gobain* case does not substantially change the final tax burden of the taxpayer. As Kostense shows, with hypothetical numbers, in case the state S applies the PE-S treaty (which means that S treats the permanent establishment as a resident of PE), the overall tax burden is only reduced if the total tax burden of S and PE decreases and if this reduction is not compensated by extra tax in R.¹⁵ In other words, the overall tax burden only decreases if the tax burden (the S withholding tax and the PE credit) negotiated under the S-PE treaty is inferior to the tax burden resulting from the R-S treaty, and if additionally state R exempts the profits of the permanent establishment. Kostense still asks whether, taking into account the results of his investigation, the credit method should be considered incompatible with the EC Treaty (i.e. non-discrimination and free movement), but concludes that the ECJ has already negatively solved the problem in the *Gilly* case.¹⁶

If, according to Kostense's hypothetical cases, the 'revolutionary interpretation' mainly causes a redistribution of powers among the Member States involved when state R applies the credit method,¹⁷ and, as pointed out by the author, the competence to the distribution of powers between the source and the residence also belongs to the Member States, as confirmed in the *Gilly* case, a broad understanding of non-discrimination does not seem to be very useful.¹⁸

Moreover, as has been mentioned by some authors¹⁹ and by the majority of the OECD Member States, this broader interpretation would certainly encourage treaty shopping. In triangular cases, this encouragement would mean that enterprises resident

⁹ See, for example, Josef Schuch, 'Bilateral Tax Treaties Multilateralized by the EC Treaty', in *Multilateral Tax Treaties, New Developments in International Tax Law* (Kluwer Law International and Linde Verlag, London, The Hague, Boston, Wien, 1998), pp. 39-40;

¹⁰ See, among others, Jan Wouters, 'The Principle of Non-discrimination in European Community Law', *EC Tax Review* 1999/2, p. 102; Josef Schuch, n. 9 above, pp. 36ff.

¹¹ See, arguing that in case of discrimination, one may ask which of the states concerned is responsible for it, Franz Wassermeyer, 'Does the EC Treaty Force the Member States to Conclude a Multilateral Tax Treaty?', in *Multilateral Tax Treaties*, see n. 9 above, p. 19.

¹² See Josef Schuch, n. 9 above, pp. 47-48. Paul Farmer, 'EC Law and National Rules on Direct Taxation: A Phoney War?', *EC Tax Review* 1998/1, pp. 13ff.

¹³ See OECD, *Triangular Cases*, R (11)-10, point 37.

¹⁴ *Ibid.*, R (11)-5, points 13 and 14, R (11)-10, point 35.

¹⁵ H.E. Kostense, n. 7 above, pp. 228-229.

¹⁶ *Ibid.*, pp. 229ff. The problem had been raised before: see Moris Lehner, 'Limitation of the National Power of Taxation by the Fundamental Freedoms and Non-discrimination Clauses of the EC Treaty', *EC Tax Review* 2000/1, pp. 11 and 14; see also Klaus Vogel, 'Some Observations regarding Gilly', *EC Tax Review* 1998/3, p. 150.

¹⁷ See H.E. Kostense, n. 7 above, pp. 226-227.

¹⁸ *Ibid.*, pp. 228-229, 232; cf. Hans van der Hurk, 'The European Court of Justice Knows its Limits (A Discussion Inspired by the Gilly and ICI Cases)', *EC Tax Review* 1999/4, pp. 211ff.

¹⁹ See, for example, Heinz Jirousek, 'Der Fall Saint-Gobain im Lichte der österreichischen DBA-Anwendungspraxis', *Internationales Steuerrecht* 1999, n. 2, pp. 606-607.

in states which exempt profits of permanent establishments located outside their territory would tend to attach their assets to permanent establishments located in states of low taxation.²⁰

Many other questions related to the scope of non-discrimination, but which I merely want to raise, have been occupying commentators:²¹ should a conventional rule which eliminates double taxation also be applied to Member States with which no double taxation convention has been concluded? If, according to a bilateral treaty, the state of residence gives a credit to compensate double taxation of non-resident permanent establishment profits, is it discriminatory not to give this credit to a Member State with which no double taxation has been celebrated? And what if this bilateral treaty has been celebrated with a third country?

3. The *Metallgesellschaft* case: non-discrimination and most-favoured-nation clause

3.1. Non-discrimination in respect of group of companies taxation

In the *Metallgesellschaft* case, Metallgesellschaft Ltd and Metal and Commodity Company Ltd were resident in the UK and paid dividends to their parent companies resident in Germany, being therefore required to pay the advanced corporation tax (ACT), which would later be credited against the main corporation tax (MCT) for which they were liable.

The parent companies maintained, in the main proceedings, that they suffered a cash-flow disadvantage which subsidiaries of parent companies resident in the UK did not incur, as the latter could make a group income election, being then exempted from the ACT. This disadvantage amounted to indirect discrimination of nationality,²² and in fact, the Court considered the following contrary to Art. 52, s. 76 of the Treaty:

'to afford companies resident in that Member State of benefiting from a taxation regime allowing them to pay dividends to their parent companies without having to pay advanced corporation tax where their parent company is also a resident in that Member State but to deny them that possibility where their parent company has its seat in another Member State.'

The Commissioners of Inland Revenue and the Attorney-General contended that ACT was introduced in order to ensure that the company making the distribution, made a payment to match the credit or income tax exemption given to the shareholder.²³ Also, even in case group companies resident in the UK had chosen the 'group income election', the payment of ACT was required when payments were made by them outside the group.²⁴

It may not be legitimate to argue that extending group income election to non-resident parent companies would allow resident subsidiaries to avoid taxation, because the ACT would never be charged,²⁵ however, we think that abolishing the ACT in payments to non-resident parent companies might

make difficult the controlling of the payments made by the subsidiary to its parent company.

The Court upheld that 'affording resident subsidiaries of non-resident companies the possibility of making a group income election would do no more than allow them to retain the sums which would otherwise be payable by way of ACT until such time as MCT falls due. They would thus enjoy the same cash flow advantage as resident subsidiaries of resident companies, there being no other difference - assuming equal bases of assessment - between the amounts of MCT for which two types of subsidiary are liable in respect of the same accounting period' (s. 54); however, contrary to this reasoning and contrary to what is mentioned in s. 57, in this case the risk of tax avoidance in one or some of the Member States involved (those with higher tax burdens) might increase.

The risk of tax avoidance in the EC in relation to associated enterprises, while neither a company tax base nor a unitary method of taxation is adopted,²⁶ should not be ignored.

Among the OECD Member States, determination of attributable profits is made according to Arts. 9 and 7 of the OECD Model, i.e. according to the arm's length principle. Let us recall that in the bilateral treaties, associated enterprises (with juridical personality) are only taxed in the state of residence, their profits being determined by the adequate rules of domestic tax law. However, as a limit, the Contracting States must respect the arm's length principle, which indicates that business profits should be taxed by the state where 'they economically originate'.²⁷ Thus, in the case of associated enterprises, the residence of the company and the source of the taxable profits tend to coincide. Besides, not only the source but also the residence states must respect the arm's length principle.²⁸

Article 9 of the OECD Model formulates the arm's length principle as a restriction for adjustment of profits of associated enterprises. It is further concerned with economic double taxation, that may result from adjustment by a Contracting State, establishing adequate procedures to eliminate it.²⁹

²⁰ OECD, *Triangular Cases*, R (11)- 11, point 39.

²¹ See, for example, Franz Wassermeyer, n. 11 above, pp. 22-23.

²² Joined cases C-397/98 and C-410/98, ECJ, 8 March 2001, Sections 30 and 31 (26ff.) of the case.

²³ Joined cases C-397/98 and C-410/98 (*Metallgesellschaft and others*), Opinions of the Advocate-General Fenelly, 12 September 2000, point 11.

²⁴ *Ibid.*

²⁵ Joined cases C-397/98 and C-410/98, ECJ, 8 March 2001, points 52ff: namely because the ACT is not a tax on dividends but rather an advance payment of corporate tax, which is later (in the MCT) recovered by compensation.

²⁶ On the subject, referring to Fritz Bolkestein's plan, Heleen Nijkamp, 'Ambitious Plan for EU company Tax Reform Fails to Address Critical Issues', *EC Tax Review* 2002/1, pp. 2-3.

²⁷ Klaus Vogel, *DBA Doppelbesteuerungsabkommen, Kommentar*, München, C.H.Beck'sche Verlagsbuchhandlung, 3rd ed., (1996), Article 9(1), points 7 and 10.

²⁸ *Ibid.*, Article 9(1), point 16. But even in case of adjustment, internal law is also the legal basis to do it, as without internal adjustment rules, the adjustment will not be possible.

²⁹ *Ibid.*, Article 9 (1), point 10.

The arm's length principle is therefore based on separate accounting, as it aims at differentiating among the different branches and subsidiaries of the associated enterprises,³⁰ and this separate accounting means that the Contracting States determine the profits of associated enterprises, and eventually make adjustments, applying their domestic tax law.

If the 'group income election' in the UK had been extended to resident subsidiaries with parent companies abroad, it would not be incompatible with the arm's length principle, as it is not connected with any fiscal unity or other consolidation provisions for taxation purposes. In the UK, groups of companies only benefit from some provisions covering the exemption of ACT payments,³¹ the transfer of losses, the transfer of assets and the payment of dividends, interest and royalties within a group.

The problem in the *Metallgesellschaft* case is not substantially different from the one analyzed in the *ICI* case,³² which concerned the granting of a tax relief in respect of trading losses incurred by non-resident subsidiaries (of a resident holding company beneficially owned by ICI). In both cases, neither a unitary method of taxation allowing members of associated enterprises to be taxed on the basis of the group's aggregate profits,³³ nor a formula that would divide up the overall profits among the various parts of the EC-based company is required,³⁴ because they do not directly interfere with the domestic rules of assessment of tax bases. In other words, they do not require a new method of allocation of profits among Member States.

However, the absence of a unitary method of taxation and respective formula of allocation of tax revenues, connected with ECJ decisions such as *ICI* and *Metallgesellschaft* may have indirect effects in the assessment of domestic tax bases. For example, in the case of tax relief granted to a resident company in respect of losses incurred by a non-resident subsidiary, it is not possible to avoid that the same losses are in the subsequent accounting year once again deducted from the profits made by the same subsidiary in its state of residence - as long as the legislation of the state of residence allows the aforementioned deductions. And in the *Metallgesellschaft* case, we may consider that ACT had an anti-avoidance objective, in the context of the arm's length principle and transfer pricing rules.

If we now add to this what we have said about the 'revolutionary approach' of the *Saint-Gobain* case, and the possible incompatibility of the credit method with non-discrimination and free movement, we may conclude that not every type of double taxation convention rules may be the object of a non-discrimination judgment, which also means that non-discrimination principle does not avoid the necessity of a harmonization process. This point was stressed in the *Gilly* case.³⁵ We may further conclude that both the EC Treaty non-discrimination principle and equal treatment as a constitutional principle in Member States suggest the conclusion of a multilateral treaty.³⁶

3.2. The most-favoured-nation clause

In the *Metallgesellschaft* process, in case extension of group income election was refused to the plaintiffs, it was asked if it was consistent with Arts. ex-6, ex-52, ex-58 and ex-73b of the EC Treaty to deny a tax credit to a company resident in another Member State when it granted such a credit to resident companies and to companies resident in certain other Member States by virtue of a double taxation convention. The Advocate-General and the Court were cautious enough not to move a step further in the interpretation of non-discrimination, proclaiming a most-favoured-nation clause.³⁷

EC law does not directly impose a most favourable treatment³⁸ which is in general rejected in tax law, based on the principle of reciprocity.³⁹

Coming back to the concept of non-discrimination which prohibits application of different rules to similar situations, a formally coherent reasoning would demand that, in double taxation convention rules, a most-favoured-nation principle applies. Otherwise, bilateral treaties resulting from bilateral negotiations, apply different rules to similar situations (cf. *Metallgesellschaft* case). This result occurs, even if we consider that the non-discrimination principle only requires a comparison between residents and non-residents; in any case, the fundamental rights of free movement would apparently be better assured by a most-favoured-nation clause.⁴⁰ There are, however, several arguments against the application of a most-favoured nation to EC member States bilateral conventions.

Besides the fact that, in the *Metallgesellschaft* case, both the Advocate-General and the Court did not require such a clause to be applied, the authority to conclude tax treaties in the EC still belongs to the Member States, as results from Art. 293 of the EC Treaty⁴¹ and was reaffirmed in the *Gilly* case. More-

³⁰ *Ibid.*, Article 9 (1), point 17.

³¹ Meanwhile abolished.

³² C-264/96, *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)*, ECJ, 16 July 1998. Cf. J. David B. Oliver, 'The impact of EU Non-discrimination Provisions in UK Corporate Law', *EC Tax Review* 1998/3, pp. 173-174; Hans van der Hurk, n. 18 above, pp. 219ff.

³³ Klaus Vogel, n. 28 above, Article 9(1), point 17(a).

³⁴ *Ibid.*, Article 7(3) and (4), points 95-96.

³⁵ C-336/96, *Mr. and Mrs Gilly v Directeur des Services Fiscaux du Bas-Rhin*, ECJ, 12 May 1998.

³⁶ See Franz Wassermeyer, n. 11 above, p. 17.

³⁷ Joined cases C-397/98 and C-410/98, Opinions of Advocate-General Fenelly, 12 September 2000, point 57; ECJ, 8 March 2001, point 97. During the oral argumentation of the *Schumacker* case, an indirect question on most-favoured-nation treatment was raised, but an answer was avoided: Albert J. Rädler, 'Most-Favoured-Nation Concept in Tax Treaties', in *Multilateral Tax Treaties*, n. 9 above, pp. 8-9.

³⁸ See Franz Wassermeyer, n. 11 above, p. 21.

³⁹ Albert J. Rädler, n. 38 above, pp. 3ff.

⁴⁰ Albert Rädler, 'Most-favoured-nation Clause in European Tax Law', *EC Tax Review* 1995/2, pp. 66-67; Michael Lang, 'Die Zukunft des Internationalen Steuerrechts in Europa', in *Die Zukunft des Internationalen Steuerrechts, Schriftenreihe zum internationalen Steuerrecht* (Wien, Linde Verlag, 1999), Band 10, pp. 83-84.

⁴¹ See Franz Wassermeyer, n. 11 above, p. 18.

over, such a clause should not be declared relevant, because it may not be guaranteed that it effectively contributes to decrease the taxpayer's overall tax burden. For example, in the *Saint-Gobain* case, the involved EC Member States would have respectively to apply the most beneficial withholding tax and tax credit. But, if, in a triangular case, the R state applies the credit method it still would not be guaranteed a decrease in the tax burden, much depending on the total net of conventions celebrated by the involved Member States and the predicted amounts of withholding taxes and credits.⁴²

On the other hand, a most-favoured-nation clause, leading to a non-harmonized multilateral regime of double taxation conventions, would create an incentive to treaty shopping and eventually result in multiple non-taxation, as Klaus Vogel demonstrates in his example of a loan extended by resident A in Brussels to B in Munich, secured by immovable property situated in the same town.⁴³

These arguments demonstrate that, in case the Court required application of a most-favoured-nation clause, the contours of non-discrimination would still become more obscure.

4. Non-discrimination as an instrument to free movement: a substance over form reasoning underlying comparison of taxpayers

4.1. Substantially comparable situations

In some of the previously mentioned cases, the complete judgment on discrimination goes beyond the traditional comparison between a resident and a non-resident taxpayer. For example, in the *Saint-Gobain* case, the analysis of non-discrimination in the source state would require a comparison between two non-residents (the non-resident subsidiary and the permanent establishment) - the question being whether the meaning of the non-discrimination principle covers this comparison.

In other cases (including perhaps *Saint-Gobain*), a non-discrimination judgment implies evaluation of the whole tax burden which is a consequence of the close relation of the EC concept of non-discrimination with the fundamental freedoms.⁴⁴ In EC law, non-discrimination is not an end in itself but instrumental to fundamental freedoms.⁴⁵ ⁴⁶ In principle, the EC Treaty accepts the international tax law elements of connection 'residence' and 'source', i.e. accepts a different tax treatment of residents and non-residents (cf. Art. 58, s. 1(a) of the EC Treaty), if they are not in a comparable situation.

Comparable ('the same') situations are those that because benefiting of free movement, become 'substantially', though not 'formally' the same: the judgment of non-discrimination implies a 'substantial over form' analysis, a *wirtschaftliche Betrachtungsweise*, or a typological interpretation.⁴⁷ The 'substantial over formal' evaluation is either directly expressed in the EC Treaty when branches and subsidiaries are equally considered,⁴⁸ or taken into account by the interpreter

in the concrete situation (when the Court considered Mr. Schumacker should be treated as a Belgian resident in order to assure free movement of persons). This reasoning leads us to the following preliminary conclusions.

- If it becomes necessary, in order to verify if Mr. Schumacker (or Mr. Wielockx) were discriminated in Belgium (or in the Netherlands), to examine how they are taxed in the residence state, we are no longer examining how S taxes residents and non-residents (basic analysis of non-discrimination) but going beyond a non-discrimination point of view, and paying attention to free movement requirements.
- If, according to a substance over form interpretation of non-discrimination, two taxpayers are deemed to be in a comparable situation if they have a common connection to the tax system of one Member State,⁴⁹ then, in triangular cases the state of connection may not discriminate between passive investment of a permanent establishment and of a subsidiary.

After all, interpretation of the EC Treaty non-discrimination principle means that the source state may no longer trust the connecting elements 'source' and 'residence' taxation on which internal and conventional tax regimes are based.⁵⁰

⁴² See other examples indicated by Albert J. Rädler, n. 38 above, p. 10.

⁴³ Klaus Vogel, 'Problems of a Most-Favoured-Nation Clause in Intra-EU Treaty Law', *EC Tax Review* 1995, pp. 264-265. See also Moris Lehner, 'Der Einfluss des Europarechts auf die Doppelbesteuerungsabkommen', *Internationales Steuerrecht* 2001, p. 336.

⁴⁴ About 'the development of the non-discrimination clauses into prohibitions of restrictions', and 'as an extension of the fundamental freedoms', Moris Lehner, n. 16 above, pp. 7ff., and also Lehner at n. 44 above, p. 331.

⁴⁵ Harald Schaumburg, *Internationales Steuerrecht, Aussensteuerrecht, Doppelbesteuerungsrecht*, 2nd ed. (Köln, Dr. Otto Schmidt Verlag, 1998), p. 44.

⁴⁶ Against the idea that the 'overall tax burden' may underlie the judgment of discrimination, Josef Schuch, n. 9 above, pp. 48-49; Michael Lang, n. 1 above, pp. 36ff. The author also criticizes the reference to the OECD Model as an argument to justify discrimination, because the Model has no binding effect (pp. 34-35).

⁴⁷ See, among others, about these concepts, Tipke and Lang, *Steuerrecht*, 16th ed. (Köln, Dr. Otto Schmidt Verlag, 1998), pp. 155-157; Larenz and Canaris, *Methodenlehre der Rechtswissenschaft, Berlin*, 3rd ed. (Heidelberg, Springer Lehrbuch, 1995), pp. 293ff.

⁴⁸ In an economical (substantial) perspective, permanent establishments are not different from a subsidiary, and the fact is that under internal tax laws, their tax bases are normally subject to the same rules. See Josef Schuch, n. 9 above, p. 41. However, we find this aspect a result from the underlying similar realities.

⁴⁹ Lyons, 'Discrimination against individuals and enterprises on grounds of nationality: direct taxation and the European Court of Justice', *EC Tax Journal* 1995/6, p. 35; Josef Schuch, n. 9 above, p. 40.

⁵⁰ Considering that the ECJ jurisprudence is not cautious enough, and considering that 'territorial grounding of tax law results from the domestic link of tax liability as framed in the provisions on unlimited and limited tax liability' and that this 'link...is an essential precondition for realizing income in a given state', Moris Lehner, n. 16 above, pp. 11ff.

If residence (and eventually source) are no longer automatic satisfactory elements to differentiate EC taxpayers' liability, a non-discrimination judgment, because connected with free movement, may imply the analysis of global income and global tax burden in the source as well as in the residence state (and in the permanent establishment state). It has adequately been stressed by commentators that if Mr. Schumacker had been taxed in Germany (in the absence of a bilateral tax treaty with Belgium), Belgium would not be obligated to tax him as a resident.⁵¹

In international tax law, the concept and regime of permanent establishments reflect the diverging interests of net capital exporting and net capital importing countries, whereas in EC law these diverging interests should be substituted by the EC Internal Market perspective.⁵² That is why, according to the EC Treaty, freedom of establishment should equally include subsidiaries and branches. However, as Moris Lehner points out, if an 'internal market, in the sense of a market which is homogeneous in its basic structures, is an important and desirable goal', it 'cannot be achieved simply by interpreting the EC Treaty'.⁵³

4.2. The case of associated enterprises

In the case of associated enterprises, the substance over form reasoning is targeted at the tax rules discriminating resident companies associated to non-resident ones (or with permanent establishments abroad). In the *Metallgesellschaft* case, once again the ECJ interpreted non-discrimination and free movement as requiring equal treatment in comparable situations: 'a resident subsidiary of a company resident in another member State is liable to Main Corporation Tax (MCT) in the United Kingdom in respect of profits in the same way as a resident subsidiary of a resident parent company' (s. 53). The court accordingly considered that the legislation of the UK, with regard to the right to make a group income election, created a difference in treatment between subsidiaries resident in the UK depending on whether or not their parent company had its seat in the UK (ss. 43 and 44).

As pointed out above, the judgment according to which limiting the right to make a group income election to subsidiaries resident in the UK with resident parent companies is discriminatory, would lead to a very complex situation if the group income election had any consequences in determining the tax base. Although the non-discrimination principle was coherently applied by the Court in the *Metallgesellschaft* process, in case it had consequences on determination of the tax bases, it would require renegotiation of double taxation conventions on the basis of another formula of apportionment of profits among Contracting States.

5. Does non-discrimination apply to every type of rule of double taxation conventions?

Double tax conventions, although recent law, already form a materially autonomous system. It disposes of

its own interpretation rules, personal scope, distributive rules of taxation of the source and resident Contracting States, rules on income allocation like the arm's length principle, methods of elimination of double taxation and developing own language. This implies that discrimination and free movement problems may not be solved by subjecting every treaty rule to these principles or by applying a most-favoured-nation clause (either limited to the applicable double taxation conventions, or the most-favoured-nation clause in absolute terms).

Contrary to what some authors have been advocating,⁵⁴ we are of the opinion that the cohesion of bilateral treaties together with the recognized competence of the EC Member States in celebrating them (Art. 293 of the EC Treaty), justify the differentiation.⁵⁵ In the absence of a multilateral treaty, and in respect of the identified rules below, bilateral treaty rules may be different from what would be the ideal solution to the EC (for example, in respect of the method of allocation of profits), and may vary from negotiation to negotiation (i.e. from treaty to treaty).

Taking into consideration the already vast jurisprudence on non-discrimination in income tax matters, and departing from the quite recent examples of the *Saint-Gobain*, *Gilly* and *Metallgesellschaft* cases, we propose a classification of the bilateral treaty rules (based on the OECD Model) which are not to be examined under the non-discrimination principle.

- Rules concerning the scope of double taxation conventions: it is not worth advocating that non-discrimination requires the source state to treat the permanent establishment as a resident of PE, because the final tax burden depends on the amount of withholding tax negotiated between S and PE states, and on the method adopted by R to eliminate double taxation of profits of a non-resident permanent establishment. The ECJ has held it discriminatory to apply different rules to similar situations or to apply the same rule to different situations, but has not considered it discriminatory to apply a different rule to a taxpayer who is not under the scope of a tax convention. If the taxpayer is a resident of neither of the two states, the double taxation convention between PE and S will not apply. Accepting this reasoning, in a

⁵¹ Among others, see Moris Lehner, n. 16 above, p. 10; Franz Wassermeyer, n. 11 above, pp. 24-25.

⁵² Ultimately, under this perspective of Community free movement, it does no longer matter that the PE has no legal personality and that the capital importing and exporting countries fight for the tax revenues.

⁵³ Moris Lehner, n. 16 above, p. 12.

⁵⁴ Among others, Michael Lang, n. 1 above, pp. 32 ff.; Franz Wassermeyer, n. 11 above, pp. 23, 27.

⁵⁵ Let us remind that in case of competence belonging both to the EC and the Member States, as the case is, the Council and the Commission agreed on a general principle of Community law, according to which 'national competence is the rule and the competence belonging to the Community is the exception'. See Maria Luísa Duarte, *A Teoria dos poderes implícitos e a delimitação de competências entre a União Europeia e os Estados-membros* (Lisboa, Lex, 1997), p. 338.

triangular situation, only the PE state would have to respect the non-discrimination principle which already results from the OECD triangular cases report and comments 51-54 to Art. 24, s. 3 of the OECD Model.⁵⁶

- Rules containing definitions (general definitions contained in Arts. 3 to 5 of the OECD Model and definitions of income): for instance, it is not possible to compare a permanent establishment with a resident company in order to apply 'correctly' a bilateral treaty regime (i.e. in order to respect non-discrimination), if the definition and/or the minimum period required in order to recognize the existence of a permanent establishment in the source state varies within the net of conventions of the mentioned state. In this case, it seems that one should compare among non-residents enterprises and eventually consider a most-favoured-nation clause.⁵⁷ However, if we take the example of two conventions celebrated by S, one requiring the minimum of six months activity in order to recognize a permanent establishment and the other requiring twelve months, how could it be assured which was the correct term? Would it be right to apply here the most-favoured-nation clause if it is expressly (and correctly) recommended in the OECD Commentaries that one should verify each situation in order to conclude whether there is a 'fixed place of business' or if there are activities 'habitually' exercised by persons acting on behalf of an enterprise?
- Rules concerning the methods to eliminate international double taxation: the methods to eliminate double taxation are still under the sovereignty of the Member States, as decided in the *Gilly* case, and therefore, any discrimination resulting from the credit method mechanism is not considered to violate the non-discrimination and free movement principles.⁵⁸
- Rules concerning allocation of profits: some domestic tax rules related to the assessment of tax bases of groups of companies, like the consolidated accounts of resident groups of companies; this kind of rules may not be considered discriminatory, as OECD Member States follow the arm's length principle and therefore base taxation of multinational enterprises in separate accounting, the tax base being determined according to internal tax rules.

Thus, we may say that both non-discrimination principle and fundamental freedoms should be respected by the double taxation convention rules, but do not intend to modify the scope (persons and taxes covered) of the conventions, the definitions (permanent establishment, for instance)⁵⁹ and the chosen methods of distribution of revenues among Member States (like, for example, the arm's length rule or the credit method for elimination of double taxation). Otherwise, it is not certain that the taxpayer would have an advantage, and, in many cases, there would only be a redistribution of tax powers among the EC Member States. Furthermore, we may not

forget that most of the Member States are civil law systems, where the role of creative jurisprudence in matters of rule of law (such as tax law) is debated and the analogy forbidden.⁶⁰

The ECJ has been ruling questions related with tax rates,⁶¹ deductions,⁶² deductions of losses⁶³ exemptions and tax credits.⁶⁴ Neither the non-discrimination principle, nor a most-favoured nation clause would, in relation to these matters, cause much disorganization of double taxation conventions. Besides, the rule of law is not a problem in this respect, as non-discrimination merely requires extending the regime to a non-resident. The ECJ, exercising its task in order to guarantee 'unitary interpretation', has developed its own principles of interpretation and autonomous concepts, forbidding recourse to internal tax law concepts.⁶⁵ However, regarding the above classified rules, a non-discriminating judgment would mean an evaluation of alternative concepts or regimes and therefore a substitution of the legislator by the ECJ.

In the end, this proves that a harmonization process is still necessary. As the non-discrimination principle is not sufficient to guarantee equal treatment of taxpayers in comparable situations within the EC, a multilateral treaty or, at least, the developing of some material tax principles, would be recommended.⁶⁶ Independently of the discussion about how far should income tax harmonization go, Franz Wassermeyer has identified, among other authors, the following relevant cases where the non-discrimination principle does not prove to be totally efficient:⁶⁷ two resident taxpayers

⁵⁶ This case should be handled by a multilateral tax treaty: see Josef Schuch, n. 9 above, p. 36.

⁵⁷ This is an example of Franz Wassermeyer, n. 11 above, p. 25.

⁵⁸ And as pointed out by Moris Lehner, the exemption method may 'lead to preferential treatment of an enterprise with foreign capitalization over an enterprise with domestic capitalization', which is not neutral to the internal market: Moris Lehner, n. 16 above, p. 14.

⁵⁹ They either belong to what Klaus Vogel calls 'Objektatbestand' (designation of the particular object to which the distributive rule of the convention will apply), or to the 'Metatbestand', when they contain requirements under which the distributive rule will apply: Vogel, n. 28 above, section 48.

⁶⁰ See Klaus Vogel and Christian Waldhoff, *Grundlagen des Finanzverfassungsrechts* (Heidelberg, CF Müller, 1999), pp. 307 ff.

⁶¹ Cf. C-107/94, *p.H. Asscher v Staatssecretaris van Financiën*, ECJ, 27 June 1996.

⁶² Cf. C-80/94 *G.H.E.J. Wielockx v Inspecteur der directe belastingen*, ECJ, 11 August 1995; C-264/98, *ICI*, ECJ, 16 July 1998.

⁶³ Cf. C-141/99 *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v Belgische Staat*, ECJ, 14 December 2000.

⁶⁴ C-307/97 *Saint-Gobain ZN*, ECJ, 21 September 1999.

⁶⁵ Harald Schaumburg, n. 46 above, pp. 43, 44ff.

⁶⁶ Harmonization is also recommendable in order to avoid the harmful effects of competition of tax systems as an alternative model to harmonization. See on the subject Wolfgang Schön, 'Tax Competition in Europe - the Legal Perspective', *EC Tax Review* 2000/2, pp. 92ff. Proposing a multilateral tax treaty, Michael Lang, n. 41 above, pp. 189ff; Josef Schuch, 'EC Law Requires Multilateral Tax Treaty', *EC Tax Review* 1998/1, pp. 29ff; Helmut Loukota, 'Multilateral Tax Treaty versus bilateral Treaty Network', in *Multilateral Tax Treaties*, n. 9 above, pp. 85ff.

⁶⁷ Franz Wassermeyer, n. 11 above, pp. 22ff. See also the analysis of Josef Schuch, in respect of 'different treatment of comparable situations' at n. 9 above, pp. 39ff.

with or without a connection to another state (international export neutrality); two residents with comparable connections to different states; two non-resident taxpayers with comparable resident income.⁶⁸

6. Free movement and double non-taxation in the EC

In international tax law, double taxation and double non-taxation are understood as part of the same problem.⁶⁹ Contracting States of double taxation conventions recognize their counterparts' right to apply their internal law general anti-abuse clauses, and the Limitation of Benefit clauses are widely spread in OECD Member States conventions.⁷⁰

As it is known, the OECD Committee on Fiscal Affairs and its working groups advise Member States of bilateral treaty solutions potentially leading to tax abuse, and make suggestions of anti-abuse clauses. Taking again the example of the OECD report on triangular cases, most of the consulted delegations have considered that Arts. 10, 11 and 12 of a double tax convention justify source exemption of the permanent establishment passive income even if the residence state does not tax, and independently of the location of the permanent establishment receiving that income.⁷¹ As this interpretation gives companies the incentive to place their assets generating passive income in permanent establishments located in low tax states, the OECD recommends that an anti-abuse clause be adopted although satisfactory solutions have not yet been found.⁷²

Let us remember that in points 53 to 55 of the triangular cases report, the situation where income arises in state S and is paid to a non-resident permanent establishment located in a tax haven, is characterized as problematic; it is accordingly recommended that countries which decided expressly to recognize application of the convention to a non-resident permanent establishment in either of the two Contracting States, should not do so if the PE state did not tax in the normal way.⁷³ Moreover, the fairness of a solution given to taxation of passive investment income attached to a permanent establishment depends much on the methods for elimination of double taxation adopted: if the residence state exempts the profits of the permanent establishment, there will be an incentive to treaty shopping. Triangular cases are a good example to confirm that analysis of the tax regime, applied in all the states involved, is necessary in order to avoid double non-taxation. This simultaneously shows that bilateral tax conventions, not being an ideal instrument to cope with triangular cases, have their own cohesion and are at least formally conducted by the principle of reciprocity.⁷⁴ Furthermore, taxation of triangular cases within the bilateral conventions regulation, shows how dangerous a 'revolutionary' approach of ECJ jurisprudence - namely the *Saint-Gobain* case - may be.

When non-discrimination in the European Community is discussed, it is seldom stressed that EC-approved directives also provide for anti-abuse rules and do not prohibit application of internal law general anti-abuse clauses. In addition, negotiations of double

taxation conventions, as well as of EC directive proposals seek as far as possible to avoid loopholes, which allow treaty shopping or avoidance behaviour. Moreover, Art. 58 of the EC Treaty also points out that free movement of capital does not prohibit Member States from taking relevant measures in order to control tax avoidance and tax evasion. We do not find such a safeguard in respect of the right of establishment because tax avoidance behaviour is supposedly more difficult to carry on or, from another perspective, easier to control. However, as free movement of capital is associated with free movement of establishment and services, Art. 58 may be applicable in connection to them. Thus, free movement of any passive investment (assets, bonds, and even letting of patents and similar property) including when attached to a non-resident permanent establishment may be (tax) restricted in case of tax abuse.

Also, notwithstanding the direct applicability of non-discrimination rules, a correct interpretation of the EC Treaty in income tax matters has to include interpretation of the meaning of the unanimity rule on the approval of directives.^{75, 76} No doubt this rule may not withdraw the direct applicability of non-discrimination, but a correct interpretation must be a systematic one, and the unanimity rule in tax law matters substantially means that - notwithstanding free movement rules - some matters should be handled neither easily nor hastily. On the contrary,

⁶⁸ The preclusion of non-resident taxpayers from tax treaties (as occurs in the triangular cases) justifies multilateralization of the bilateral treaties. See Josef Schuch, n. 9 above, p. 36 (pp. 35ff).

⁶⁹ Klaus Vogel and co-authors, *On Double Taxation Conventions, A Commentary to the OECD-, UN- and US Model Conventions for the Avoidance of Double Taxation of Income and Capital*, 2nd ed. (Kluwer Law and Taxation Publishers, Deventer, Boston, 1991), points 109ff, especially points 116-117.

⁷⁰ *Ibid.*, points 116-117. About the possible conflict between the Parent-Subsidiary Directive (and the proposed Interest-Royalty Directive) and some LOB clauses, Frans Vanistendael, 'Impact of European Tax Law on Tax Treaties with Third Countries', *EC Tax Review* 1999/3, pp. 165-166; John F. Avery Jones, 'Flows of Capital between the EU and Third Countries and the Consequences of Disharmony in European International Law', *EC Tax Review* 1998/2, pp. 103ff.

⁷¹ OECD, *Triangular Cases*, R (11)-7, point 20.

⁷² In fact, the OECD Commentaries on Art. 21 refer that when income generating assets are attached to a permanent establishment essentially to take advantage of s. 2 of Art. 21 in the treaty between state R and state P then an addition should waive its application; or state R should not apply Article 21, s. 2 if it considers the attachment of the assets to the permanent establishment is fictitious. In cases where large numbers of transactions are carried, for instance, in the case of banks or insurance companies, the first method is very difficult to apply. And in both cases, states exempting tax profits made by permanent establishments are disregarded: OECD, *Triangular Cases*, R (11)-7, point 20.

⁷³ *Ibid.*, R (11)-15 and (11)-16.

⁷⁴ Criticizing the 'reciprocity' and 'coherence' as a justification to discrimination, Michael Lang, n. 41 above, pp. 36ff.

⁷⁵ See Moris Lehner, n. 16 above, p. 13, point 3.4.

⁷⁶ Although the Commission proposed a Qualified Majority Voting for certain tax areas. See Frits Bolkestein, 'Taxation and Competition: The Realization of the Internal Market', *EC Tax Review* 2000/2, pp. 81-82.

they demand careful analysis.⁷⁷ Previous to capital movement harmonization, the Court of Justice never recognized a direct applicability to non-discrimination of capital movements because it feared economic damages to the EC; however, the possibility of tax avoidance must also be considered a relevant aspect.⁷⁸

Therefore, the ECJ may not make an extensive interpretation of EC Treaty competence. The frontier between interpretation and modification of the EC Treaty must be kept, as the German Constitutional Court stressed in relation to the Maastricht Treaty.⁷⁹

Last, but not least, the most recent package of proposals related to income tax harmonization, even if once again not (until now) too fruitful, expresses concern regarding harmful tax competition. As a matter of fact, at the ECOFIN Council on 1 December 1997, Member States declared the decrease of capital income tax revenues undesirable and therefore agreed to negotiate a directive on taxation of savings income and to create the working group of the Code of Conduct which has given particular attention to damaging tax competition.⁸⁰ If combating tax avoidance and harmful tax competition among Member States is in the first range of priorities of the European

Community, namely of the Council of Ministers and the Commission, it would be contradictory that the Court of Justice interpreted the non-discrimination principle in absolute terms: for instance, proclaiming that bilateral treaties should be applied according to a most-favoured-nation clause.

⁷⁷ See in this sense, Moris Lehner, n. 16 above, pp. 5-6ff.

⁷⁸ Although the Court, until now, has only accepted the 'cohesion of the tax system', as a justification for discriminatory treatment, we may say that 'cohesion' in the *Bachmann* case was closely related to control of tax avoidance.

⁷⁹ In this sense, Juliane Kokott, 'Die Bedeutung der europarechtlichen Diskriminierungsverbote und Grundfreiheiten für das Steuerrecht der EU-Mitgliedstaaten', in 'Grundfreiheiten im Steuerrecht der EU-Staaten', *Münchener Schriften zum Internationalen Steuerrecht*, (München, Moris Lehner, 2000, Verlag C.H. Beck), pp. 5-6; Moris Lehner, 'Begrenzung der nationalen Besteuerungsgewalt durch die Grundfreiheiten und Diskriminierungsverbote des EG-Vertrages', in *Europa- und verfassungsrechtliche Grenzen der Unternehmensbesteuerung*, Band 23 der Veröffentlichungen der Deutschen Steuerjuristischen Gesellschaft e.V. (Jürgen Pelka Hrsg.) (Köln, Verlag Dr. Otto Schmidt, 2000), pp. 280-281.

⁸⁰ See Wolfgang Schön, n. 68 above, pp. 96 ff.