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Tax treaties between Member States and Third States: 'reciprocity' in bilateral tax treaties and non-discrimination in EC law¹

Klaus Vogel, Professor, University of Munich, Daniel Gutmann, Professor, University Paris Panthéon-Sorbonne and Ana Paula Dourado, Professor, University of Lisbon

1. A Multilateral Framework Treaty between the EU and third states

It is clear that a third state is not bound to EC law: neither to the EC principle of equality nor to the market freedoms. On the other hand, there seems to be common ground that EU states are prohibited by the EC Treaty from concluding treaties with third states which violate these EC principles. Even though no direct reference is made in the EC Treaty to this prohibition, it is to be inferred from Art. 307 of the EC Treaty, which requires Member States to eliminate incompatibilities with EC law arising from treaties concluded before the entry into force of the EC Treaty (or after the EC Treaty's entry into force, but before a Member State adheres to the EC), or ultimately to terminate them.²

In any case, a bilateral tax treaty that violates EC law is valid as such and may be applied by the third state.³ This is of practical importance as in the case of anti-abuse clauses in Double Taxation Conventions, the third state has a clear interest in a unilateral application of such clauses, even if Member States are prevented from applying them.

If we consider the subject of tax treaties between Member States and third states and their compatibility to Community law, the following related questions need then to be asked.

1. Does it follow from the premise that EU states are prohibited by the EC Treaty from concluding treaties with third states which violate EC principles, that EU states are prohibited from including in their double taxation conventions with third states rules which differ - at least in part - from treaties they have concluded with other third states or which differ from those which other EU states have included in their treaties with third states, or which give a more favourable treatment than the one resulting from treaties concluded with (the) other Member States?
2. Does it follow from that same premise, that Member States are prohibited from including in

their Double Taxation Conventions with third states, anti-abuse clauses that limit the access of tax treaty benefits to companies, entities or individuals of other Member States (LOB clauses), and from applying CFC clauses either contained in their domestic law or in double taxation conventions, to resident companies (which directly control a company resident in a Member State (MS 2) and indirectly a company resident in a third state (TS 1) and neither MS 2 nor TS 1 taxes their income)?

The answers to these questions are generally negative, as differences between bilateral tax treaties are unavoidable due to the following reasons:

- domestic tax law is different,
- domestic private law - law of contracts, company law - is different (we may think of the various types of companies ranging from fully transparent partnerships to opaque corporations and of the many hybrids between these types), and

¹ The following article has its origin in the Workshop of experts organised by the European Commission in Brussels on 5 July 2005, more exactly in the panel dedicated to 'Tax Treaties between Member States and Third Countries'. Its contents do not correspond exactly to the oral interventions, also because the *D* judgment was still unknown when the meeting started. Some topics of Hugh Ault's oral intervention are mentioned or quoted in the text, with the authorization of the author. Paragraphs 1 and 6 were written by Klaus Vogel, 3 and 5 by Daniel Gutmann and 2, 4, 7 and 8 by Ana Paula Dourado (the author would like to thank Prof. Hugh Ault for his invaluable contribution with critical comments, ideas and materials).

² This perspective accepts that Community law takes precedence over international public law, which needs to be discussed: See, Moris Lehner, Vogel and Lehner, 'Einleitung, DBA und europäisches Recht', *DBA, Doppelbesteuerungsabkommen, Kommentar* (Auflage, München, 2004), sections 258-262, 194-195.

³ *Ibid.*, s. 260; Luc Hinnekens, 'Compatibility of bilateral tax treaties with European Community Law. The rules', *EC Tax Review* 1994, p. 162; Frans Vainistendaal, 'Impact of European taxation law on tax treaties with third countries', *EC Tax Review* 1999, p. 166; Malherbe and Delatre, 'Compatibility of LOB Provisions with EC Law', *ET* 1996, pp. 14-15.

- there may be factual differences (for example the existence of continental shelf).

Assuming that the *D* judgment makes it clear that no most-favoured-nation clause applies between EU Member States, we will analyse whether the ECJ should have differentiated between rules on allocation of taxation powers and rules conferring tax advantages. We will try to demonstrate that the ECJ should not get involved in a casuistic classification of rules within tax treaties.

We will further ask whether there is still some space for an implementation of a most-favoured-nation clause in case a third state is involved and will argue that the reasoning in the *D* case is also applicable to tax treaties between EU Member States and third states.

We will at last try to demonstrate that anti-avoidance rules within tax treaties between an EU state and third states are not *per se* incompatible with EC law. Some of them, like the CFC clauses, may still be considered rules on the allocation of taxation powers. Others, like LOB clauses, are entitlement rules to the benefits of the provisions of the tax treaties. Anti-avoidance rules require a case-by-case analysis of conformity to free movement and non-discrimination, and EU states may not demand from a (all) third state(s) that a uniform set of anti-avoidance rules is included in all tax treaties with EU states. The fact that no most-favoured-nation clause is applicable to tax treaty rules on allocation of taxation powers as was decided in the *D* case applies with equal force in relation to anti-abuse clauses.

From these reasons it may also be inferred that a uniform double taxation convention between the EU and third states would need so many exceptions, that it cannot be recommended. Even if Member States agreed on a multilateral double taxation convention - which is not likely in the short term - a third state would not accept as a point of departure for such uniform treatment the 'most favoured rules' in force between that third state and the EU states. It is not likely, for example, that the United States would accept the inclusion of the less restrictive LOB clause negotiated with an EU state in such a multilateral convention. On the contrary, as Hugh Ault pointed out, it would accept anything but a very restrictive LOB clause if it had to take a 'one size fits all' approach. Would this convert the 'most favoured nation clause' into a 'most unfavoured nation clause'?⁴ In this context, what might at best be feasible would be a *framework treaty* which covers the issues clearly related to the basic principles of the European Union, but leaves the other ones to the treaty-making power of the Member States.

2. Non-discrimination of non-residents, rules on allocation of taxation powers and rules conferring tax advantages

The *Saint-Gobain*⁵ and *Metallgesellschaft*⁶ decisions raised many expectations concerning the ECJ position about a most-favoured-nation clause being applicable

to tax treaties concluded by Member States.⁷ The *Open Skies*⁸ and the *Gottardo* cases⁹ increased that expectation, by deciding that a (more favourable) treatment¹⁰ given by a Member State in a bilateral Treaty to a third state national and excluding other Member States nationals, may violate the non-discrimination principle and the market freedoms (the Member State violates the EC Treaty and the result of either the Member State or the third state applying the Treaty implies a violation of the EC Treaty).

In the *Gottardo* case, the Court considered that the balance of a bilateral treaty was not at risk, when it required the social security regime given to nationals of a non-member country to be extended to nationals of Member States, under identical circumstances of contribution:¹¹

'the unilateral extension by the Italian Republic, to workers who are nationals of other Member States, of the benefit of having insurance periods which they completed in Switzerland taken into account for the purpose of acquiring entitlement to Italian old-age benefits would in no way compromise the rights which the Swiss Confederation derives from the Italo-Swiss Convention and would not impose any new obligations on that country.'¹²

We would agree that reciprocity in such conventions is not equivalent to reciprocity in tax treaties, because the give-and-take basis, if present in social security conventions, is not a bargain respecting different rules on the allocation of sovereign powers, but only one set of rules (regarding expenditure with social security benefits). The same is even more true in respect of the *Open Skies* case. The bilateral free aviation agreements between the US and some EU states were being renegotiated according to a more liberal model, and the restriction of benefits to the companies resident in the Contracting States violated, according to the ECJ, the fundamental freedoms of the nationals of the other EU states.¹³ All the rights and obligations within the *Open Skies* bilateral agreements

⁴ Again as Hugh Ault mentioned during his intervention in the Workshop in Brussels on 5 July 2005.

⁵ C-307/97, 21 September 1999.

⁶ C-397/98 and C-410/98, 8 March 2001.

⁷ Ana Paula Dourado, 'From the Saint-Gobain to the Metallgesellschaft Case: scope of non-discrimination of permanent establishments in the EC Treaty and the Most-Favoured-Nation Clause in EC Member States Tax Treaties', *EC Tax Review* 2002, p. 147.

⁸ C-446/98, 5 November 2002.

⁹ C-55/00, 15 January 2002.

¹⁰ Considering that neither Italy nor the United-Kingdom were condemned on the ground of a most-favoured-nation treatment (i.e. neither in the *Gottardo* case nor in the *Open Skies* case), see below, Daniel Gutmann, s. 3, and Pasquale Pistone on the *Gottardo* case, 'National treatment for all non-resident EU nationals: looking beyond the D Decision', *Intertax* 2005, p. 413.

¹¹ Sections 36-39.

¹² Section 37. Budgetary reasons invoked by the Italian Government were not accepted by the ECJ.

¹³ See Adam Craig, 'Open your eyes: What the "Open Skies" cases could mean for the US tax treaties with the EU Members', *IBFD* 2003, p. 64.

implied reciprocity and favourable treatment (like free access of routes and granting of traffic rights), but no sharing of potentially overlapping sovereign powers.

Although neither the *Open Skies* nor the *Gottardo* cases dealt with tax issues, they both raised the doubt whether a most-favoured-nation treatment was required in respect of bilateral tax treaties concluded among Member States and bilateral tax treaties concluded between Member States and third states.

Even if we consider that the effect of the *Gottardo* and the *Open Skies* cases was limited to extend the personal scope of tax treaties with third states, the decision in the *D* case was different from the one shown in the *Open Skies* and *Gottardo* cases. *D* was a German national, resident in Germany. *D*'s assets consisted of 10 per cent of real property situated in the Netherlands and 90 per cent situated in Germany. The ECJ rejected that not granting a tax allowance to *D* is incompatible with Community law, even though an allowance was granted to residents in Netherlands under domestic tax law and to residents in Belgium under the Belgium-Netherlands Tax Treaty applicable at the time. According to the ECJ decision, *D* is neither in a comparable situation to that of a resident of the Netherlands (s. 41 of the decision); nor to a resident of Belgium (ss. 59ff. of the decision) as Arts. 56 and 58 of the EC Treaty do not preclude that reciprocal rights and obligations apply only to persons resident in one of the two Contracting Member States - that is an inherent consequence of bilateral double taxation conventions.¹⁴

It results from the ECJ decision that the rule that was under analysis in the Belgium-Netherlands Double Taxation Convention - an allowance given to a non-resident in respect of a property tax - was a rule on the allocation of powers of taxation (resulting in a 'benefit' to the taxpayer) between the Contracting States and therefore under the competence of Member States.¹⁵ In fact, the Court held that a 'rule as that laid down in Article 25 (3) of the Belgium-Netherlands Convention cannot be regarded as a benefit separable from the remainder of the Convention, but is an integral part thereof and contributes to its overall balance' (s. 62).

As is known - as the ECJ made it clear in the *Gilly* case¹⁶ - rules on the allocation of taxation powers, negotiated with a certain margin of discretion conferred by the OECD Model (in the case of OECD Member States), are not subject to a non-discrimination judgment (or a judgment relating to its conformity to free movement of production factors in the EU).

Dennis Weber, who argued that *D* was discriminated in the Netherlands in comparison to a Belgium national and resident in Belgium, refuted that the aforementioned allowance is a rule on the allocation of taxation powers. According to Weber, the allowance granted under the Belgium-Netherlands Convention disguises a tax advantage, because Belgium does not have a wealth tax and therefore reciprocity - which should always underlie rules on the allocation of taxation rights - is not achieved.¹⁷ The fact that the allowance is not a rule on the allocation of taxation powers, and therefore not excluded from a judgment

on its compatibility to EC law, would mean that the ECJ should have considered that *D* was in a comparable situation to a national and resident in Belgium with real property in the Netherlands and was consequently being discriminated. Still according to the author, if we are dealing with rules conferring tax advantages, a most-favoured-nation clause could be affirmed.¹⁸

Under the Belgium-Netherlands Tax Treaty, the 'wealth constituted by real property ... is taxable in the State where the property is situated' (Art. 23(1)). Article 25(3) of the same Treaty is a rule on 'non-discrimination' and provides that '[n]atural persons resident in one of the two Member States are entitled in the other to the personal allowances, concessions and reductions which are granted by the latter to its own residents by reason of their civil status or dependents'. Article 25(3) does not change the allocation rule - the taxation right of the source state in respect of property located in that state.

It is true that the tax allowance granted by the source state depends on the taxpayer's personal and family situation. It will normally involve consideration of ability-to-pay elements which are usually concerns of the state of residence,¹⁹ according to a concept of 'economic allegiance'.²⁰ And the provision in Art. 24, s. 3, 2nd sentence of the OECD Model clarifies that non-discrimination of non-residents does not oblige a 'Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and

¹⁴ Section 61, ECJ case, C-376/03, 5 July 2005.

¹⁵ As they are competent to negotiate and conclude bilateral treaties as recognized in *Gilly*, *Saint-Gobain* and *De Groot*. In this respect, Art. 293, s. 2 of the EC Treaty, which recommends negotiation of multilateral tax treaties to eliminate double taxation within the EU, has been understood as a subsidiary rule.

¹⁶ *Gilly*, C-336/96, 12 May 1998, s. 30.

¹⁷ Dennis Weber, 'Most-favoured-nation treatment under tax treaties rejected in the European Community: Background and analysis of the *D* Case', *Intertax* 2005, pp. 436, 441-442.

¹⁸ *Ibid.*, pp. 442-443.

¹⁹ Even if the principles of source and residence are no longer satisfactory to tax cross-border situations, and even though there is no longer a strict dichotomy between source and residence, as the recent IFA General Report on the subject illustrates (A. Schindel and A. Atchabahian, 'Source and residence: new configuration of their principles', *CDFI*, 90a, 2005, pp. 84-85; cf. e.g. the enlarged version of the German Report, M. Lehner and E. Reimer, 'General Thema I: Quelle vs. Ansässigkeit - Wie sind die grundlegenden Verteilungsprinzipien des Internationalen Steuerrechts austatiert?' *ISfR* 2005, p. 542), this assertion is still valid. The idea goes back to the 'Report on Double Taxation', submitted to the Financial Committee by Bruins, Einaudi, Seligman and Stamp (League of Nations, Geneva, 1923), p. 26; Cf. *Rapport et Résolutions Présentés par les Experts Techniques au Comité Financier de la Société des Nations* (1925), pp. 14, 15, 31 and 32.

²⁰ Cf. Klaus Vogel, 'Worldwide vs. source taxation of income - A Review and re-evaluation of arguments', I, III, *Intertax* 1988, pp. 211, 212, 219, 260, 261 and 395. The concept of economic allegiance or 'wirtschaftliche Zugehörigkeit', was introduced by Georg Schanz, and substituted the 'juridical allegiance', or 'state allegiance' as the only legitimate criterion for taxation: 'Zur Frage der Steuerpflicht', *Finanzarchiv* 1892, pp. 366, 396 and 407; and it was adopted in the 'Report on Double Taxation', *ibid.*, by Bruins *et al.*, 26 ff.; Cf. Edwin Seligman, *Double Taxation and International Fiscal Cooperation* (New York, 1928), p. 102.

reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents'. According to the OECD commentaries to this provision, 'the second sentence of s. 3 ... is designed to ensure that such persons do not obtain greater advantages than residents'.

Supposing that in the situation under analysis, a resident in Belgium owning real property in the Netherlands obtains greater advantages than a resident in the Netherlands in a comparable situation, it would still be difficult to determine whether this is a tax expenditure.

A casuistic analysis involving classification of rules within a Double Taxation Convention, differentiating between rules on allocation of taxation powers and rules conferring (hidden) tax advantages would lead to many difficulties. For instance, if we considered that the allowance connected with the property tax and granted by the source state, could not be deemed an allocation rule, due to lack of reciprocity, we would also have to reject that the different withholding tax rates on interest or dividends applied only by one Contracting State (as source state) were allocation rules (let us suppose that only one out of the two Contracting States taxes interest or dividends of non-residents, and the 'reciprocity' fails). Concrete application of transfer pricing rules by Contracting States would raise the same kind of problems.

If the ECJ gets involved in distinguishing genuine allocation of rights provisions from tax advantages or tax expenditure within a given double taxation convention, it will certainly find it troublesome and a slippery task, as has happened before within the GATT dispute panel. Besides, whereas in the GATT analytical process, tax subsidies are deviations from the *normative structure* of a country's tax system,²¹ in a tax treaty emerging from bilateral negotiations it is not possible, or at least it is very difficult, to identify the *normative structure*.²² Otherwise, any deviation from domestic law or model convention would be a tax expenditure or ultimately every source country concession in a treaty would be a tax expenditure.

In addition, as we will illustrate in the next paragraph, even the distinction between allocation of rights rules (or allocation of tax powers) and rules on the exercise of rights is not so clear as a first analysis might indicate.

3. Lawyers in the *Open Skies* with *D*... Is the solution of the *D* judgment also applicable where a third state is involved?

One of the many questions raised by the *D* judgment of the ECJ²³ is whether it affects the tax relationships between the EU Member States and third states. We shall focus on a specific problem: assuming, as previously mentioned, that the *D* judgment makes it clear that no most-favoured-nation clause implicitly applies between EU Member States,²⁴ the question is whether there is still some space for an implementation of such a most-favoured-nation clause where a third state is involved.

This problem is not a new one. It was raised during the workshop of experts organised under the auspices of the European Commission on 5 July 2005²⁵ and some authors have already pointed out that the most-favoured-nation mechanism, if admitted between EU Member States, might have a dramatic impact upon the relationship between EU Member States and third states.²⁵

To illustrate the point, let us consider a case presented by Mike Waters:²⁶

- EU Member State X has concluded a tax treaty with EU Member State Y providing for source taxation of interest at a rate not exceeding 10 per cent;
- EU Member State Y has concluded a tax treaty with the United States providing for no source taxation of interests;
- may a resident of State X therefore claim that State Y should also abstain from withholding any tax on interests paid to him on the ground that State Y does so where the beneficiary is a resident of the United States?

The question might, at first sight, seem to be deprived of relevance. The absence of any withholding tax, being a consequence of the exclusive taxing right granted to the state of residence of the beneficiary, seems to pertain to the allocation of the tax jurisdiction and to escape the ECJ's control. However, it does not seem that this objection should be overestimated. As a matter of fact, where a state enters into a convention and agrees to give up its domestic withholding tax on outbound interests, there is no

²¹ On the subject, see Paul McDaniel, 'The Impact of trade agreements on Tax systems', *Intertax* 2002, p. 167. See also the Agreement on Subsidies and Countervailing Measures, 15 April 1994.

²² According to Paul McDaniel both the 'provisions in a country's legislation and in its bilateral treaties to implement the country's decisions regarding the fundamental issues constitute the 'normative' or 'benchmark' structure of its tax system': *ibid.*, p. 167. But this presupposes that every bilateral treaty implements a country's decisions regarding the fundamental tax issues, while rules within bilateral treaties may reflect the possible result of tough negotiations.

²³ C-376/03, 5 July 2005.

²⁴ 'Assuming that': the consequences of the *D* case may even be discussed in that respect, but this is not the subject of the present contribution. In particular, it has been alleged that the *D* judgment does not prevent the most-favoured-nation mechanism from applying where an EU Member State lays down discriminative rules pertaining to the exercise of his tax jurisdiction (see Ph. Derouin, 'Différences de traitement fiscal résultant des conventions de double imposition entre Etats membres de l'Union européenne. Clause de la nation la plus favorisée (NPF) ou chalandage fiscal (*treaty shopping*)?', *Dr. fisc.* 2005, nos. 30-35, p. 1288).

²⁵ See in particular M. Waters, 'A Tax Treaty for Europe? Most-Favoured Nation and the Outcome of the 'D' and Bujara Cases in the European Court of Justice', *European Taxation*, August 2005, p. 347; P. Pistone, 'National Treatment for All Non-resident EU Nationals: Looking Beyond the D Decision', *Intertax* 2005, vol. 33, no. 10, p. 412; M. C. Bennett and C. A. Dunahoo, *The NFTC Tax Treaty Project: Towards a U.S. Tax Treaty Policy for the Future: Issues and Recommendations*, May 2005, p. 21.

²⁶ See n. 27 above, p. 348. For further illustrations of the substantial variations affecting the tax treaties concluded by the US with EU Member States, see M. C. Bennett and C. A. Dunahoo, *ibid.*, p. 16.

practical difference between saying that it waives its taxing right (which is a matter of allocation of tax powers) and saying that it virtually keeps its taxing right but reduces it to nil (which is a matter of exercise of tax powers).²⁷ Besides, it is not certain that the ECJ systematically refuses to check the allocation of taxing rights.²⁸ It does not seem, therefore, that this distinction should prevent scholars and even the ECJ from going further into the debate.

Let us now try to answer the initial question in three steps: first, it will be asked whether the *D* judgment precludes a taxpayer, resident of Member State X, from claiming that he should enjoy the tax treatment granted by State Y to a third state. We shall then consider other ECJ decisions in order to check whether they lead to opposite conclusions. Finally, we shall draw some conclusions of this reasoning (ss. 4 and 5).

The *D* judgment obviously does not contain a direct answer to the problem at stake, since the tax treaties involved in that case were concluded between EU Member States only. However, the *D* judgment undoubtedly contains a general approach to tax treaties which produces effects beyond the factual situation of the case.

As mentioned before, according to the *D* judgment, it is not legally relevant to compare the situation of two non-residents persons belonging to different countries. As the Court put it, 'a taxable person resident in Belgium is not in the same situation as a taxable person resident outside Belgium so far as concerns wealth tax on real property situated in the Netherlands' (s. 61). This different situation stems from the very fact that bilateral conventions differ from one another and reach a unique balance between Contracting States. In this respect, a specific Article of the Convention 'cannot be regarded as a benefit separable from the remainder of the Convention, but is an integral part thereof and contributes to its overall balance' (s. 62).

Such a way of reasoning relies on the aforementioned idea that a tax treaty is a coherent set of rules established by two contracting parties with conflicting interests. It assumes that those Contracting Parties have reached an economic balance through negotiation. The consequence of this approach to tax treaties is that their structure should not be jeopardized on the basis of hazardous comparisons with the situation of third state residents.

It could be interesting to compare this theory of tax treaties with the implicit theory of tax systems underlying most ECJ decisions. It indeed seems that the ECJ, which does not care so much about preserving the global coherence of domestic tax systems,²⁹ is much more worried by the eventuality of affecting the balance of tax treaties. Is this because tax treaties affect the allocation of tax sovereignty whereas the coherence of domestic systems has generally been at stake concerning the exercise of the tax powers? It may be so. However, one may observe that the overall balance of tax treaties is often nothing more than a way of preserving budgetary resources for both states... a concern which is disregarded in principle by the ECJ case law.

In any case, this general approach to tax treaties makes it pointless to distinguish between intra-EU tax treaties and tax treaties between EU Member States and third states. There is consequently no reason to reconsider the implementation of a tax treaty between Member States X and Y on the sole ground that it is less advantageous than a tax treaty concluded by EU Member State Y with a third state.

Along the same line, one may remind the Court's assertion that apart from the Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, no unifying or harmonizing measure for the elimination of double taxation has yet been adopted at Community level and that EU Member States have not yet concluded any multilateral convention to that effect under Art. 293 of the EC Treaty. This observation, which reveals the scarce level of harmonization of direct taxes within the EU, is even more true in the case of relationships between third states. Therefore, the outcome of the reasoning seems to be even more justified where a third state is involved.

However, one cannot endorse this way of reasoning without considering possible counter-arguments. As a matter of fact, one could argue that the most-favoured-nation-clause problem arises in a different context where a third state is concerned. To put things in a non-legal way, is there not something wrong in accepting that an EU Member State treats a third state resident in a better way than an EU resident? Certainly, the Court has judged in *D* that an EU Member State is free not to treat equally all EU residents from other EU states. Nevertheless, this decision does not necessarily imply that an EU Member State is free to treat non-EU residents in a better way than EU residents. It is therefore necessary to wonder whether this hypothesis may find some support in other existing ECJ decisions.

The decisions which deserve reflections in that respect are the aforementioned *Saint-Gobain*, *Gottardo* and *Open Skies* judgments. If considered rapidly, the *Saint-Gobain*, *Gottardo* and *Open Skies* judgments seem to give a strong support to the idea that favourable provisions negotiated by an EU Member State with a third state should be extended also to other EU Member States. In those judgments, indeed, a resident (in *Saint-Gobain*) or a national (in *Gottardo*) of a Member State X could enjoy the benefit of a treaty concluded by a Member State Y with a third state. Also, in *Open Skies*, the ECJ ruled that an EU Member State could not exclude resident companies held by residents of other Member States from the benefit of

²⁷ Along this line, Ph. Derouin, n. 27 above, p. 1294, who thinks that withholding tax clauses belong to the set of rules governing the exercise of tax powers rather than the allocation of tax powers.

²⁸ Cf. the Working Paper *EC Law and Tax Treaties*, Workshop of Experts, TAXUD E1/FR, DOC (05) 2306, s. 29.

²⁹ It is useless to remind the reader that the 'coherence argument' put forward by Member States to justify the infringement of fundamental freedoms has almost systematically been rejected by the Court.

a treaty with a third state without infringing Art. 43 of the EC Treaty. Some authors conclude that the ECJ may already have acknowledged that a most-favoured-nation-clause applies in the relationships with third states.³⁰

However, we would say that this interpretation relies on a disputable understanding of the idea that the benefits of a treaty between Member State Y and a third state should be 'extended' to residents of Member State X. In *Saint-Gobain* and *Gottardo*, the ECJ simply accepted to treat a resident or a national of Member State X as a resident or a national of State Y for the purposes of implementing the treaty between State Y and the third state. As Pasquale Pistone has rightly pointed out, 'Mrs. Gottardo was not invoking her pension rights as to entitle her to the so-called most-favoured-nation treatment, but merely to enjoy the same rights to which Italian nationals are entitled under the social security convention with Switzerland'.³¹ Also, in *Open Skies*, the United Kingdom was condemned on the ground that there was no correct justification for excluding non-UK owned companies from the benefit of a treaty concluded with the United States. It was not ruled at all that the United Kingdom should apply the same provisions it applied with the United States in its relationship with other EU Member States. In other words, the only effect of these three judgments was to extend the *personal scope* of tax treaties with third states. However, none of these judgments have as a result to change the *substantive tax rules* provided by a tax treaty between two Member States. None of them imply to substitute the actual clauses contained in the treaty between Member States X and Y with a clause drawn out of the treaty between Y and a third country. It is therefore very bold to deduce from the ECJ's position in these cases that it would have accepted, or would accept in the future, the implementation of a most-favoured-nation clause in the relationship with third states.

4. The role of the most-favoured-nation clause in international trade versus the aim of tax treaties and intra-EU states neutral taxation

The most-favoured-nation clause is in general associated with non-discrimination of non-residents and with liberalization of international trade, but does not usually concern direct taxes, unless the treaty expressly states that.³²

Within the GATT, the most-favoured-nation clause (Art. 1(1)) means that any advantage, favour, privilege or immunity granted by any Member of the WTO to any product originating in or destined for any other country (not necessarily a WTO Member³³) shall be accorded immediately to the like product originating in or destined for the territories of all the other WTO Members, without any conditional reciprocal benefits.

Article 1(1) cannot be dissociated from the multilateral negotiations on tariff (customs duties) reductions. Whereas it is necessary to negotiate the reduction of those tariffs on a multilateral and periodical basis (Art. XXVIII of GATT), as bilateral

reduction is understood as harmful trade competition, a most-favoured-nation clause was indispensable in order to avoid circumvention of the aforementioned multilateral trade policy. Article 1(1) is therefore usually understood to concern customs duties and also other kinds of indirect taxes because in principle only such taxes can circumvent tariff reductions resulting from negotiations.³⁴

As Hugh Ault stressed in his intervention in the aforementioned workshop organized by the Commission, while in international trade the reduction and elimination of tariffs is a clear agreed goal carried out by the most-favoured nation clause, the goal of double taxation conventions is not to eliminate taxation but to eliminate double taxation. In this context, 'a concession on one point is matched by a favourable result on another and that 'package' will necessarily be different in each case, due to the differences in the tax systems'.³⁵

Besides, double taxation conventions should not help tax avoidance and therefore OECD Contracting States are also urged to preserve the application of domestic anti-abuse provisions and to look for bilateral solutions in order to prevent tax avoidance.

All these are decisive arguments for not associating a most-favoured-nation clause to non-discriminatory taxation in EC law.

Let us recall an argument mentioned above in this article, using different words.

If Arts. 56 and 58 of the EC Treaty do not preclude a rule (on allocation of taxation powers) laid down by a bilateral tax treaty from not being extended to nationals³⁶ of a Member State which is not party to that convention, and if that is 'an inherent consequence of bilateral double taxation conventions' (s. 61 of the *D* case), it is indifferent that the bilateral tax

³⁰ See E. Meier and B. Boutemy, 'Conventions fiscales bilatérales au sein de l'Union Européenne ou l'histoire d'une passation de pouvoir?', *BF* 1/05, s. 23, quoting s. 34 of the *Gottardo* judgment according to which 'when a Member State concludes a bilateral international convention on social security with a non-member country which provides for account to be taken of periods of insurance completed in that non-member country for acquisition of entitlement to old-age benefits, the fundamental principle of equal treatment requires that that Member State grant nationals of other Member States the same advantages as those which its own nationals enjoy under that convention unless it can provide objective justification for refusing to do so'.

³¹ P. Pistone, n. 28 above, p. 413.

³² As Dennis Weber recognizes: 'Most-favoured-nation ...', see n. 20 above, pp. 429-431.

³³ Borges and Infante Mota, 'National Report Portugal', *WTO and direct taxation*, hrsg. M. Lang, Herdin, Hofbauer and Wien (2005), p. 570; P. Infante Mota, *O Sistema GATT/OMC* (Coimbra, 2005), p. 114.

³⁴ Borges and Infante Mota, *ibid.*, p. 571. It is true that tax subsidies (expressed in tax allowances, credits or reductions of tax rates) may be analysed under the GATT. For example, the GATT Panel held in 1999 that the US Foreign Sales Corporation tax regime was not valid under GATT. In this case, there was a clear deviation from the domestic normative structure of the tax system.

³⁵ As Hugh Ault also mentioned during his intervention.

³⁶ Who are in a comparable situation with the nationals of the Contracting States.

treaty is concluded between Member States or between a Member State and a third state. If non-discrimination and free movement of factors of production within an internal market do not require equal tax treatment of all residents within that internal market, there is no rationale to require non-discrimination or equal tax treatment by a Member State towards all residents in the internal market in comparison to a resident in a third state.³⁷

We might add that the opposite reasoning is also true, taking into account Arts. 56 and 58 of the EC Treaty: if the doctrine underlying the *Open Skies* or the *Gottardo* cases would be applicable to taxes, the ECJ would have decided in a different way in the *D* case – two Member States would be hindered from attributing a more favourable bilateral treatment to their nationals and residents excluding nationals and residents of other Member States.

From the *D* case we can also infer the following conclusions.

- The ECJ has implicitly recognized, in the absence of EU tax harmonization, the impossibility of interstate (international) neutral taxation *lato sensu*. Accepting different rules on the allocation of rights in different double taxation conventions, the ECJ has recognized that the structure and level of intra-EU states taxation is intrinsically non-neutral.
- As the ECJ has recognized that EC law does not prohibit different tax treatment of non-residents, it has confirmed that EC law does not require capital import neutrality within the EC, and therefore it also does not require that a Member State taxes any cross-border situation according to a capital import neutrality principle.³⁸ This may be a relevant argument for justifying compatibility of anti-avoidance clauses with EC law.

5. Most-favoured-nation clause and tax treaties with third states: some conclusions and consequences

The conclusion that may be drawn from the reasoning above is twofold. From a practical point of view, it is clear that this situation is a great incentive for tax planning. For instance, what may a company, resident of EU Member State X, do in order to enjoy the tax treatment granted by EU Member State Y to interests paid to the residents of a third country Z? It may set up a subsidiary in State Z, which provides the loan to the borrower in State Y and enjoys a better tax treatment thanks to the tax treaty concluded between State Y and State Z. The interests may then be distributed to the company of State X and enjoy the parent-subsidiary regime. Of course, this kind of tax planning structure will rarely produce such an effect. It only works if the tax treaty between State Y and State Z contains neither a limitation-on-benefits clause nor a beneficial owner clause or a broadly worded thin capitalization rule. It may also be that the tax authorities of State Y will analyse this – assuming they are aware of the construction – as a way of circumventing the tax

treatment which should have applied between State Y and State X.

However, one should seriously wonder whether a sound approach does not imply to prevent such tax planning rather than to fight it *a posteriori*. A more provocative statement would be that a company, resident in State X, might also complain that the very necessity to use tax planning tools – as long as they are legally acceptable – rather than establish a direct relationship between the company resident in State Y, is an infringement of one of the fundamental freedoms.³⁹

This observation drives us to the second part of our conclusion. Let us accept that no most-favoured-nation clause applies *de jure* where an EU Member State grants a more favourable treatment to a third state resident than to an EU resident. Let us also suppose that the inconveniences of this legal solution are superior to its advantages.⁴⁰ Then the question is whether Community institutions may, under the existing state of Community law, find remedies to the inconveniences of the present situation.

The main problem here is whether Community institutions already have the power to substitute EU Member States to negotiate part or all of tax treaties with third states. According to the *AETR* judgment of the ECJ,⁴¹ 'each time the Community, with a view to implementing a common policy envisaged by the Treaty, adopts provisions laying down common rules, whatever form these may take, the Member States no longer have the right, acting individually or even collectively, to undertake obligations with third countries which affect those rules' (s. 17). This solution is justified by the idea that 'any steps taken outside the framework of the Community institutions would be incompatible with the unity of the Common Market and the uniform application of Community law' (s. 31). Also, the Court states that 'to the extent to which Community rules are promulgated for the attainment of the objectives of the Treaty, the Member

³⁷ The parallel can be drawn between a free trade zone and a customs union. A customs union is a step ahead a free trade zone. It would be non-sense to demand a common external tariff if tariffs had not been abolished among Member States of the customs union (i.e., if there were no free trade zone).

³⁸ Peggy Musgrave, *Interjurisdictional coordination of taxes on capital income, tax coordination in the EC* (Deventer, 1987), pp. 197 and 206. Capital import neutrality is associated to a concept of fair competition and requires a neutral tax policy from the state of residence: Klaus Vogel, see n. 3 above, p. 315; 'Einleitung, Internationale Aufteilung der Besteuerung, wirtschaftliche und rechtliche Aspekte', *DBA*, Vogel and Lehner, see n. 5 above, ss. 24-26.

³⁹ This argument is similar, to a certain extent, to the argument put forward by Marks & Spencer in the famous case involving the cross-border transfer of losses, where it claims that the UK group relief rules induce companies to set up foreign permanent establishments of UK subsidiaries to repatriate foreign losses, rather than foreign subsidiaries directly.

⁴⁰ These assumptions do require an in-depth demonstration, as Mike Waters rightly pointed out the many shortfalls of a rigid implementation of the most-favoured-nation doctrine in the relationships with third states (see n. 28 above).

⁴¹ Case 22-70, 31 March, 1971.

States cannot, outside the framework of the Community institutions, assume obligations which might affect those rules or alter their scope' (s. 22).

It is very difficult to be sure whether the *AETR* judgment actually produces effect in tax matters and, if it does, what kind of effect it produces. Partisans of the idea that the *AETR* judgment has consequences in tax matters will argue that 'a common policy envisaged by the Treaty' exists in the field of double tax conventions, since Art. 293 of the EC Treaty implies that Member States are, so far as is necessary, to enter into negotiations with each other with a view to securing for the benefit of their nationals the abolition of double taxation within the Community. They will also underline that the absence of unifying or harmonizing measures for the elimination of double taxation is irrelevant to determine whether European institutions have an implicit power to negotiate tax treaties with third states. Indeed, even where no common rule has actually been adopted, Art. 5 of the EC Treaty compels Member States to facilitate the Community's accomplishment of its mission and to abstain from taking any step that might jeopardize the achievement of Treaty's goals.⁴² One might consequently draw from these general principles, either that the Community implicitly has an exclusive power to negotiate tax treaties with third countries, or, more restrictively, that it has such power in the field covered by existing EC tax directives.

However, these consequences do not appear to be fully clear. As a matter of fact, it is very difficult to state to what extent there exists an EU tax policy regarding double taxation. Even if Member States have agreed to measures that have an *impact upon tax treaties*,⁴³ it does not necessarily mean that they have agreed to a *common policy concerning tax treaties*. The very fact that the Commission is now doing its best to foster a common approach on this question reveals the low level of harmonization in that respect. Along the same line, one must acknowledge, after the *D* judgment, that EU Member States are not deemed to have agreed a most-favoured-nation-mechanism between themselves. More generally, it is difficult to figure out how EU Member States, who are deemed to keep their sovereignty when it comes to allocating taxing rights inside the EU, could be deemed to have given it up in their relationships with third states.

Besides, one may wonder whether the *D* judgment does not affect the very possibility for European institutions to negotiate 'pieces' of tax treaties with third states. Certainly, existing EC directives show that EU Member States have already agreed to affect the 'overall balance' of the bilateral tax treaties between themselves, by selecting particular issues which deserve an homogeneous treatment in Europe. However, the *D* judgment is now telling us that tax treaties should be considered as a global set of rules which should not be affected in principle, even by virtue of EC law. Which argument is the most powerful one? This is indeed difficult to say.

Finally, one may wonder whether the fundamental ground of the *AETR* theory, namely the fact that individual initiatives of EU Member States towards

third states might jeopardize the effectiveness of the Treaty inside the EU, is actually present in tax matters - or at least in all tax matters. Let us consider the goals pursued by EC tax directives. Sometimes, they intend to foster the freedom of establishment. This is the case, to a certain extent, of the Parent-Subsidiary Directive and of the Merger Directive. Sometimes, they tend to foster the freedom of movement of capital: that is the case in the Savings Directive and to a certain extent in the Interest-Royalty Directive.⁴⁴ However, it is well known that, whereas the latter freedom also applies in the relationships with third states, the former only applies within the European Union. Before admitting that European institutions may negotiate directly with third states conventional clauses pertaining to the freedom of establishment, it is therefore necessary to demonstrate to what extent this is necessary to ensure the effectiveness of the freedom of establishment within the EU.⁴⁵

We do not aim, by presenting these arguments and counter-arguments, at saying that nothing could or should be done on a European level, but to highlight that the legal situation is a tricky one and that the *AETR* judgment does not produce obvious effects in tax matters. The legal situation would be much clearer if European States started by establishing common rules concerning tax treaties between themselves, before any power is granted to European institutions to negotiate tax treaties with third states. And in any case, as mentioned above, what might at best be feasible, in the present context, would be a *framework treaty* covering the issues which are clearly related to the basic principles of the European Union.

Treaty entitlement for EU citizens, for example, is an issue that could be dealt with in such a *framework treaty*. In respect of anti-abuse clauses, their compatibility with EC law requires a case-by-case judgment, but some guiding principles could be included in a *framework treaty*. The next paragraphs are dedicated to these two issues.

⁴² Opinion 2/91 (1993) ECR I-1061, ss. 10 and 11.

⁴³ EU Member States have already agreed to amend their bilateral tax conventions by adopting directives providing for the abolition of withholding taxes on some intra-EU payments of dividends, interests and royalties. The Savings Directive also has a clear impact on double taxation treaties since it attributes an exclusive taxing right to the state of residence of the beneficiary of an interest payment.

⁴⁴ This Directive also has a link with the effectiveness of the freedom to provide cross-border services.

⁴⁵ This is also why no certain conclusion can be derived from the fact that the European Commission was given the power to negotiate with third states the extension of the scope of the Savings Directive. This text is indeed connected to the freedom of capital movement, which the EC Treaty also grants in the relationship with third countries. Besides, it is obvious that, if those third states had not agreed to the implementation of the Directive, many EU residents would have delocalized their savings from EU Member States to non-EU Member States. The impact of the negotiation with the third countries upon intra-European movement of capital was therefore undisputable.

6. Universal or partial treaty entitlement for EU citizens?

It is a widespread view that 'limitation on benefit' clauses which deny treaty benefits to companies which are controlled by residents of other EU states may violate EC law. From this follows the broader question: are Member States obliged to require in their treaty negotiations that all EU residents are entitled to the particular treaty's benefits? This could be done, for example, by phrasing Art. 1 as follows: 'This Convention shall apply to persons who are residents of one or both of the contracting states or of any other Member State of the European Union'.

It seems evident that EU obligations cannot go that far. As Professor Ault pointed out in his intervention, tax treaties are bargains on a give-and-take basis. As long as the other EU states are not obliged to give residents of the other Contracting State the same benefits as are negotiated under that particular treaty, their residents cannot require that treaty's advantages.

What may be discussed is a partial treaty entitlement as has been suggested by OECD for permanent establishments. A typical permanent establishment, though it is not a juridical person, is similar to a subsidiary. Its income is subject to the tax law of the state where it is established. Thus it might be considered as a 'quasi-resident'. But one must be careful here. Not all permanent establishments are similar to subsidiaries. For example: would it be reasonable to confer treaty entitlement to building sites or construction or installation projects which are permanent establishments under Art. 5(3) of the OECD Model Convention? Or consider that under Art. 5(3)(b) of the UN Model 'the furnishing of services, including consulting services', subject to certain conditions, constitutes a permanent establishment. Would it be reasonable that such 'services permanent establishment' should have treaty entitlement?

Other tax treaties assume a permanent establishment where 'substantial equipment' is used in the state of non-residence. For example Art. 4(3)(b) of the Australia-Singapore Tax Treaty has the following wording:

'An enterprise of a Contracting State shall be deemed to have a permanent establishment and to carry on trade or business through that permanent establishment in the other Contracting State, if:

- (a) ...
- (b) substantial equipment is being used in that other State by, for or under contract with the enterprise.'

Let us ask again whether it would be reasonable to give treaty entitlement to such permanent establishment. In our view, treaty entitlement to PEs would require a particularly narrow PE definition like that in Art. 2(2) of the Parent-Subsidiary Directive.

Similar questions may be raised for other types of income. Thus, partial treaty entitlement might be considered for employees from EU states who work in another EU state for more than 183 days without becoming residents of that state. Should EU states be

obliged to require in their treaty negotiations application of Article 15 OECD MC to these employees? We do not have an answer to this question at present.

7. Are anti-abuse clauses in tax treaties or applied in connection to tax treaties concluded between EU states and third states incompatible with EC law?

Some anti-abuse clauses may be classified as rules on the allocation of taxation powers. They allow that a Contracting State taxes some items of income that, if there were no abuse, would not be taxed. We can call them *rules over rules on allocation* of taxation powers. By preventing the granting of benefits under a double taxation convention, some of these rules may be considered exceptions to the benchmark rules of allocation. CFC rules belong to this category of rules, but they are part of the benchmark rules of allocation and not exceptions, as they are complementary to the unlimited tax liability and to the credit method.⁴⁶ In other words, they may be considered an inherent part of the normative tax system and essential to prevent tax avoidance practices 'inspired by the realisation that the rates of taxation applied in various Member States vary significantly'.⁴⁷ However, contrary to other rules on allocation of taxation powers, they may be discriminatory according to the ECJ jurisprudence.⁴⁸

Other anti-abuse rules, like LOB clauses, are connected to the entitlement or non-entitlement of a taxpayer to a tax treaty. This is a question prior to the allocation of taxation between the Contracting States. This entitlement is also, in principle, under the competence of the Contracting States. However, non-entitlement of a taxpayer to tax treaties benefits may not be discriminatory (e.g. (non-)entitlement of permanent establishments, different treatment of a non-resident physical taxpayer in comparison to a resident).⁴⁹

From above it may be inferred that anti-abuse clauses applied in connection to tax treaties concluded between a EU state and a third state are not necessarily incompatible with EC law. As the judgment of compatibility requires a case-by-case analysis, this means that assuming different tax regimes within the EU, anti-avoidance clauses still have to be negotiated bilaterally. We may cite again the oral intervention of Hugh Ault, in the workshop, to illustrate the perspective of a third state in respect of these subjects: 'it appears to me - again with all modesty and deference of an outsider - that after some early attempts to take fiscal coherence of domestic systems into account, the decisions of the ECJ have given almost total priority to the Single Market idea, and

⁴⁶ Wolfgang Schön associates CFC rules to these principles and refuses their classification as anti-abuse clauses: 'Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht', *Der Betrieb* 2001, p. 945.

⁴⁷ *Marks & Spencer*, C-446/03, 13 December 2005.

⁴⁸ See, e.g. the *Lankhorst-Hohorst* case, C-324/00, 12 December 2002, ss. 26.

⁴⁹ *Moris Lehner*, n. 5 above, s. 266.

thus leading to – again at least when viewed from the outside – strange results that countries can't protect their domestic tax bases against erosion without applying the same principles, unnecessarily, to domestic transactions. Is the really a better world where countries have to apply thin capitalization rules or pricing rules domestically where they aren't needed in order to be able to apply them internationally where they are needed? Or to eliminate domestic consolidation in order to prevent the importation of foreign losses?

It seems that ss. 49 and 50 of the *Marks & Spencer* case appease these worries, as the ECJ recognizes that a discriminatory or restrictive regime may be justified on the ground of preventing tax avoidance:

'As regards... the third justification, relating the risk of tax avoidance, it must be accepted that the possibility of transferring the losses incurred by a non-resident company to a resident company entails the risk that within a group of companies losses will be transferred to companies established in the Member State which applies the highest rates of taxation and in which the tax value of the losses is therefore the highest' (s. 49).

'To exclude group relief for losses incurred by non-resident subsidiaries prevents such practices, which may be inspired by the realisation that the rates of taxation applied in the various member States vary significantly' (s. 50).

In any case, some guiding-principles relating anti-abuse clauses could be included in a *multilateral framework treaty*. For example, LOB clauses would be prohibited if they lead to economic double taxation. As we will try to demonstrate, LOB clauses seem not to be incompatible with EC law if they do not cause economic double taxation (or if they do not violate Capital Export Neutrality within the EC – *CEN* would mean here that exporting companies would pay nearly the same amount of tax whether their income has EC or third Contracting State source, and if they are taxed once in the EC territory). And CFC clauses would be prohibited if they did not observe the control test, were not limited to passive income or mobile activities and did not observe the principle of proportionality.⁵⁰

8. Some LOB clauses and CFC clauses and their compatibility with EC law

Let us now illustrate the thesis that the judgment of compatibility of LOB clauses and CFC clauses with EC law requires a case-by-case analysis with some examples. A first example corresponds to a triangular situation similar to the ones in the *Saint-Gobain* case.

MS1 is the EU state of the parent company R and MS2 is the EU state where the permanent establishment PE is situated; the permanent establishment is a shareholder of a subsidiary S1 resident in an EU state (MS3) and of a subsidiary S2 resident in a third state (TS).

In the *Saint-Gobain* case, the ECJ concluded that MS2 discriminated against the permanent establishment shareholder in comparison to a subsidiary. It was not clear though, whether permanent establishments

should be treated as residents, and whether the Court's decision would have been the same, if profits were taxed in MS1 and not exempt, and/or in case the permanent establishment were subject to a privileged tax system.⁵¹

The answers to these questions were provided by the Parent-Subsidiary Directive as amended (EC/2003/123) when Member States are involved: all of them must assure a non-discriminatory treatment in the aforementioned triangular cases. If we assume that the MS2 and MS1 have a higher level of taxation in comparison to MS3, and MS2 and MS1 apply the ordinary credit method, treating the PE as a resident does not necessarily imply lower taxation, in comparison to taxation resulting from application of double taxation convention MS1-MS3.

The present EC regime is advantageous in the case where MS2 exempts income from MS3 or applies the ordinary credit method and has lower taxation than MS3 and MS1 exempts income; or when MS1 eliminates all double taxation. It seems that Member States are not allowed to adopt either unilateral or bilateral measures to prevent this situation, taking into account ECJ jurisprudence. According to the ECJ, definition of avoidance and domestic anti-abuse measures may not be in conflict with the objectives and scope of Community law.⁵² The objectives of the Internal Market allow that production factors choose the most advantageous tax system (*Centros* case) and the consequences of avoiding domestic measures may not be considered tax avoidance as long as an economic activity is carried on in a Member State (substance test),⁵³ and as long as the favourable tax regime was not declared incompatible with the Treaty (*Eurowings* case). However, ss. 49 and 50 of the *Marks & Spencer* case seem to modify the previous ECJ jurisprudence.

If MS1 adopts the exemption method and MS2 does not tax, TS2 may invoke a LOB clause under double taxation convention MS1-TS2 and withhold tax on 100 per cent of dividends.⁵⁴

The question is whether MS1 violates Art. 10 of the EC Treaty (regarding the Community preference). We may say that *Centros* and *Eurowings* cases are not opposed to LOB clauses when third states are involved. There will be economic double taxation in TS2, the third state, but not within the EU.

Capital import neutrality is indirectly violated in this case, because although MS1 and MS2 did not tax, MS1, by accepting a LOB clause in the tax treaty with

⁵⁰ Carlo Pinto, *Tax Competition and EC Law* (The Hague, 2003), pp. 354–355.

⁵¹ Ana Paula Dourado, see n. 10 above, pp. 148–150.

⁵² See the study of Dennis Weber, *Tax avoidance and the EC Treaty freedoms, A Study of the limitations under European Law to the prevention of tax avoidance* (The Hague, 2000), pp. 176–177; and Carlo Pinto, see n. 53 above, p. 317.

⁵³ *Centros*, C-212/97; *a contrario sensu*, *X and Y II*, C-436/00, s. 61, *de Lasteyrie*, case C-9/02, s. 50; Dennis Weber, see n. 55 above, pp. 253–255.

⁵⁴ See this (a similar) example in Malherbe and Delattre, n. 6 above, p. 17.

TS2, did not avoid economic double taxation of EC shareholders.

As we concluded above that capital import neutrality is not required by EC law, neither at an international level, nor at the EU level, we are inclined to say that MS1 does not violate EC law in this case.

If the example changes to royalties or interest paid by TS2 to MS2, there would be no taxation (as MS1 adopts the exemption method and MS2 does not tax) and what has been called the 'single-tax principle' in international tax law is violated. Application of a LOB by TS2 clause would certainly be compatible with EC law in this case, as it would not cause any economic double taxation.

A very simple LOB clause in double taxation convention MS2-TS requires that resident companies of the Contracting States are controlled by residents in MS2 or TS. In this case, resident companies are treated differently according to the residence of the shareholders. MS2 may not apply the LOB clause as it would be clearly incompatible with free movement and non-discrimination. If TS applies the LOB clause and MS2 or MS1 credit the whole amount of withholding tax, there will be no economic double taxation, and EC law is not offended. Otherwise, the application of the LOB by TS seems to violate the EC Treaty (namely, Arts. 10 and 43), as MS2 and MS1 will contribute to double economic taxation.

In a third hypothetical case, PC4 is a controlled foreign company resident of a third state TS with low taxation. PC3 is the parent company of PC4 and is resident within a preferential tax regime territory in MS1, not declared as a harmful tax practice by the Code of Conduct. PC2 is the parent company of PC3 and resident of Member State MS2. PC1 is the parent company of PC2, RS the shareholders of PC1 and RS and PC1 are both residents of MS1. Double taxation convention MS2-MS1 provides for a tax sparing credit, applicable even if the dividends of PC3 are exempt in MS1.

The question is whether MS1 or MS2 may apply a CFC clause to their parent company without offending the Parent-Subsidiary Directive (and free movement and non-discrimination). Applying the Parent-Subsidiary Directive means that the Member State that taxes a deemed dividend has to credit any (income) taxes paid by the controlled foreign company (as other methods seem to be incompatible with the Directive).⁵⁵ If the companies meet the 'substantive test' criterion as the ECJ demands, the CFC clause may be considered incompatible with EC law.⁵⁶

According to the ECJ in *X and* ' case:

'refusal of the tax advantage in question on the ground that the transferee company in which the taxpayer has a holding is established in another Member State, is likely to have a deterrent effect on the exercise by that taxpayer of the right conferred on him by Art. 23 of the EC Treaty to pursue his activities in that other Member State through the intermediary of a company' (s. 37).⁵⁷

Restrictions on the Treaty freedoms are permissible only if they pursue a legitimate objective compatible

with the Treaty and are justified by imperative reasons of public interest.⁵⁸

In the example under analysis, prevention of tax avoidance may be accepted as a legitimate objective compatible with EC law, if criteria like control, passive income or mobile activities and low taxation are met. Besides, securing of efficient fiscal supervision may be also invoked as a valid justification for a CFC regime. Both prevention of tax avoidance and securing of efficient fiscal supervision must pass the proportionality test (and this may require that the purpose of tax avoidance is proved in each case).

If an establishment is founded for the sole reason of obtaining the favourable effects of the fundamental freedoms and if all other criteria required by the ECJ are fulfilled,⁵⁹ the CFC clause could be considered compatible with the EC law.⁶⁰ A general anti-abuse clause could also be applicable, if it met the ECJ criteria.

We can still imagine that PC4 in TS is subject to regular taxation. Under double taxation convention TS-MS1, TS did not withhold tax on dividends paid by PC4 to the beneficial owner PC1 resident of MS1, but excluded companies like PC3 situated in a preferential tax regime territory within MS1. It seems this is not incompatible with EC law, as it will not provoke double taxation. The problem would be different if the LOB clause were part of double taxation convention MS2-TS as it might divert investment from MS2 and TS. The problem would again be different if instead of PC4 we had a PE in TS paying interest to PC2 in MS2, and MS1 applied a CFC clause under double taxation

⁵⁵ Cf. Aigner, Scheurele and Stefaner, 'General Report', *CFC Legislation, tax treaties and EC Law* (The Hague, 2004), p. 50.

⁵⁶ See the *pro* and *contra* arguments in Aigner *et al.*, *ibid.*, p. 38f.; and Carlo Pinto, n. 53 above, p. 350. There is a restriction of the right of establishment of PC3, or a restriction of the right of a company to choosing the best corporate tax system available in the EU (351); and eventually a restriction of free movement of capital (353). In any case, CFC clauses must observe the control test, there must be low taxation in the source state, they must be only applied to passive income and observe the principle of proportionality.

⁵⁷ Case C-436/00, 21 November 2002.

⁵⁸ *Futura Participation*, C-250/95, *Jessica Safir*, C-118/96, *Eurowings*, C-294/97, *Danner*, C-136/00, *Marks & Spencer*, C-446/03.

⁵⁹ According to the ECJ, anti-avoidance measures cannot make a distinction on the ground of nationality or between domestic and cross-border situations, and measures that in spite of not making such distinction, restrict the exercise of freedom of movement or make it less attractive are also prohibited; when an anti-abuse measure results in a restriction of the freedom of movement, it must be determined whether it can be justified by a reason of general public interest as important as the EC Treaty freedoms and in conformity to the EC law; whether the private conduct results in an advantage; whether the anti-avoidance measure is appropriate to reach its objective and is proportionate to the pursued objective (the anti-avoidance measure must make a sufficiently specific link to the relevant objective circumstances that indicate avoidance and the consequences of applying the anti-avoidance measure must be proportionate to the avoidance involved). Besides, anti-abuse clauses must be applied without distinction on nationality and between internal and cross-border situations: See, for a synthesis, Dennis Weber, n. 5 above, p. 257.

⁶⁰ It seems there is consensus in this case: Aigner *et al.*, see n. 58 above, p. 39.

convention MS1-MS2. PE is an EC company but it does not fall under the scope of the Interest-Royalties Directive, as its scope is limited to the interest and royalties which have their source in a Member State.⁶¹ This case raises a relevant problem in terms of EC law and a CFC clause needs a justification.⁶²

From the above described examples, we think we can reasonably conclude that EU states are not prohibited by the EC Treaty from including anti-avoidance clauses in their double taxation conventions with third states. Application of those clauses by EU states, as well as application of domestic anti-avoidance clauses preserved in their bilateral Double

Taxation Conventions, is dependent on the casuistic judgment of its compatibility to EC law.

⁶¹ Denying protection of income flowing from third countries to the EU may raise a question of discrimination: see Frans Vanistendael, n. 6 above, p. 165.

⁶² Raising serious doubts that the traditional justification for applying CFC clauses (low taxation in the source country) is going to be accepted by the ECJ, Wolfgang Schön, see n. 49 above, p. 943; considering that 'CFC rules that constitute special regulations for low-taxed CFCs with passive income abroad are not justifiable under Community law', Michael Lang, 'CFC legislation and Community Law', *ET* 2002, p. 379.