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Limitation on Benefits Clauses and EU Law

Limitation on Benefits clauses have been a feature of tax treaties entered into by the United States and various Member States in recent decades in an effort to prevent treaty shopping. In this article, the author examines their compatibility with EU law through an analysis of existing ECJ case law. After concluding that LOB clauses are in violation of EU law, the consequences of such incompatibility are analysed.

1. Introduction

Limitation on Benefits clauses (LOB clauses) are anti-avoidance devices that have been consistently used by the United States in its tax treaties since the 1980s. These clauses operate by restricting the personal scope of tax treaties and denying treaty benefits to persons that do not fulfill certain 'attachment to the jurisdiction' requirements. They are mostly aimed at counteracting abusive schemes, such as treaty shopping.[1]

In an EU context, the issue arises whether or not such clauses are compatible with the four fundamental freedoms, as defined in the Treaty on the Functioning of the European Union (TFEU) and shaped by the European Court of Justice (ECJ). The ECJ has consistently held that the freedoms (in particular the freedom of establishment) can only be restricted in exceptional circumstances and that such restrictions (if justified) have to be proportional (*lato sensu*) to the objective(s) pursued. Moreover, on the EU side, other European institutions have raised serious doubts on the issue.

Bearing the above in mind, it is evident that LOB clauses in tax treaties between Member States and the United States may create difficulties regarding compatibility with EU law since they target and preclude the benefits granted by the TFEU, in particular, the freedom of establishment. A clear solution, in the author's opinion, has not yet been found (even following the *Open Skies*[2] and the *ACT GLO*[3] cases).

If the ECJ were to decide that LOB clauses were, in fact, incompatible with EU law, all Member States that have such clauses in their tax treaties with the United States would be obliged to renegotiate their tax treaties or even terminate them. As stated above, these two different approaches (the creation of a single market, on the one hand, and prevention of abuse, on the other) are the result of the conflicting perspectives of two major 'players' (the United States and the European Union) in the world market. If both were taken to the extreme, tax treaty negotiation between the Member States and the United States would, ultimately, prove to be impossible, with great prejudice to the objectives of tax treaties, in particular, to the facilitation of world trade.

In an area where equilibrium is certainly needed, this article aims at clarifying an issue, the compatibility of LOB clauses with EU law, that has been dealt with in an ambiguous and confusing manner, in the hopes that this discussion will contribute to the elimination of measures that contaminate the legal background of the EU-US market.

2. Can Tax Treaties Restrict the Functioning of the Internal Market?

2.1. Tax treaties and EU law

Although ECJ case law on the compatibility of national provisions with EU law is extensive and requires that nationals of other Member States not be, directly or indirectly, discriminated against in comparison to nationals of a given Member State, the ECJ has had less opportunity to discuss the idea that tax treaties should be viewed as national legislation of the Member States and, thus, are also required to comply with EU Law.[4]

In *Bouanich*,[5] the ECJ stated that, "the tax system under the Franco-Swedish agreement, [...] forms part of the

* This article is based on the Adv LLM paper the author submitted in fulfilment of the requirements of the 'Master of Advanced Studies in International Tax Law' degree at the International Tax Center Leiden (Leiden University). The author can be contacted at jose.guerra@alumni.itc-leiden.nl. The author would like to express his deepest gratitude and admiration for Mr Paolo Arginelli's work as supervisor of this paper. His input and constant remarks contributed invaluably to this work. All mistakes and omissions are, in any event, the author's sole responsibility.

1. Treaty shopping is defined by the United States in its Technical Explanation to the 2006 US Model Income Tax Treaty as, "the use by residents of third states of legal entities established in a contracting state with a principal purpose to obtain the benefits of a tax treaty between the United States and the other Contracting State". See also one of the first judicial approaches to treaty shopping by the United States in *Aiken Industries v. Commissioner* 56 T.C. 925 (1971).
2. ECJ, 5 November 2002, Case C-466/98, *Commission of the European Communities v. United Kingdom of Great Britain and Northern Ireland*; ECJ, 5 November 2002, Case C-467/98, *Commission of the European Communities v. Kingdom of Denmark*; ECJ, 5 November 2002, Case C-468/98, *Commission of the European Communities v. Kingdom of Sweden*; ECJ, 5 November 2002, Case C-469/98, *Commission of the European Communities v. Republic of Finland*; ECJ, 5 November 2002, Case C-471/98, *Commission of the European Communities v. Kingdom of Belgium*; ECJ, 5 November 2002, Case C-472/98, *Commission of the European Communities v. Grand Duchy of Luxembourg*; ECJ, 5 November 2002, Case C-475/98, *Commission of the European Communities v. Republic of Austria*; and ECJ, 5 November 2002, Case C-476/98, *Commission of the European Communities v. Federal Republic of Germany*.
3. ECJ, 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*.
4. See Pasquale Pistone, "The Impact of European Law on the Relations with Third Countries in the Field of Direct Taxation", 34 *Intertax* 5 (2006), p. 235.
5. ECJ, 19 January 2006, Case C-265/04, *Margaretha Bouanich v. Skatteverket*.

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legal background to the main proceedings […]." In that decision, which consolidates what the ECJ had already stated in *Avoir Fiscal*[6] and *Saint-Gobain*,[7] the ECJ basically takes the position that tax treaties are part of the set of national rules that are presented by the national court and that must comply with EU law in the sense that they cannot be a source of restriction or discrimination.[8]

However, it is important to note that the ECJ has no competence to interpret tax treaties since they are beyond the scope of Community competencies. This means that the ECJ cannot be called upon to decide on disputes between the Member States (or between Member States and taxpayers) arising under tax treaties entered into amongst themselves or between a Member State and a third state. This does not mean, however, that it cannot review those treaties in regard to compatibility with EU law.[9]

It must be recalled that EU law takes precedence over national legislation of the Member States, which includes tax treaties entered into with other Member States or with a third state. Member States are always required to follow EU law and may be liable for any breach of their obligations.[10]

2.2. Getting inspiration from non-tax case law – the "*Open Skies*" cases

Some years ago, the ECJ was faced with a situation where, under treaties concluded between Member States and a third state (the United States), air traffic rights were only granted to companies that complied with a nationality clause included in each of those treaties. Accordingly, a company whose share capital was primarily owned by non-nationals of the Member State where it was established was denied the benefits of the treaty (by the third country, the United States) in accordance with such a nationality clause.

These nationality clauses had a similar structure to the currently used LOB clauses in that they restricted the application of a given treaty to persons that fulfilled certain attachment to the jurisdiction requirements, thus curtailing the possibility of jurisdiction shopping by nationals/residents of Member States that have no such treaty, in order to get access to those benefits.

When referring the case to the ECJ, the Commission based its claim (namely) on the fact that the use of nationality clauses infringed the freedom of establishment in that companies owned by non-nationals were not granted the rights under the treaty.

As the Advocate General points out in Para. 124 of his Opinion that,[11] "by virtue of Article 52 of the Treaty Member States are required to accord national treatment to the companies of other Member States established in their territory […]". In the same paragraph, the Advocate General goes on to explain that, "Member States cannot discriminate against an airline established in their territory but owned or controlled by nationals of other Member States, in respect of access to transatlantic routes".

The Member States argued, on the other hand, that even there was discrimination it was due to the US' action and could not be imputed to the Member States.[12] A second argument put forward by the Member States was that the inclusion of such a clause was an imposition of the United States during treaty negotiation and had nothing to do with the Member States.

The ECJ dismissed both arguments.

As regards the first argument, it considered that:

> […] the conduct of the United States of America is not relevant in this action, since infringement of Article 52 of the Treaty consists in the granting by the United Kingdom to the United States of America of the right […] which it negotiated [and that] the direct source of that discrimination is not the possible conduct of the United States of America but Article 5 of the Bermuda II Agreement, which specifically acknowledges the right of the United States of America to act in that way.[13]

In this manner, the ECJ dismissed the Member States' argument on the basis that, even though the discrimination was a direct consequence of a US action, it had its (legal) origin in a provision agreed upon by the Member States.[14] Accordingly, the Member States were liable for such breach.

As for the second argument, the Advocate General was equally emphatic, expressing the view that Member States have to fulfil their obligations under EU law, and that the fact that such a clause was imposed by the United States was not a good enough argument to discharge Member States from their Community obligations.[15]

Even though the *Open Skies* cases did not involve any taxation principles or issues, the author is of the opinion that these ECJ decisions have an important impact on the issue of the compatibility of LOB clauses in tax

6. ECJ, 28 January 1986, Case 270/83, *Commission of the European Communities v. French Republic.*
7. ECJ, 21 September 1999, Case C-307/97, *Compagnie de Saint-Gobain Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt.*
8. See also Pasquale Pistone, "Towards European International tax law", 14 *EC Tax Review* 1 (2005), p. 4.
9. Ruth Mason, "U.S. Tax Treaty Policy and the European Court of Justice", 59 *Tax Law Review* 65, p. 68.
10. See Tom O'Shea, *EU Tax Law and Double Tax Conventions* (London: Avoir Fiscal Limited, 2008), p. 199 and Julian Ghosh, *Principles of the Internal Market and Direct Taxation* (Oxford: Key Haven, 2007), p. 80.
11. ECJ, Advocate General Tizzano's Opinion, 31 January 2002, Joined Cases C-466/98*Commission of the European Communities v. United Kingdom of Great Britain and Northern Ireland*, C-467/98 *Commission of the European Communities v. Kingdom of Denmark*, C-468/98 *Commission of the European Communities v. Kingdom of Sweden*, C-469/98 *Commission of the European Communities v. Republic of Finland*, C-471/98 *Commission of the European Communities v. Kingdom of Belgium*, C-472/98 *Commission of the European Communities v. Grand Duchy of Luxembourg*, C-475/98 *Commission of the European Communities v. Republic of Austria* and C-476/98 *Commission of the European Communities v. Federal Republic of Germany.*
12. Under the *Open Skies* agreements, it was up to the United States to deny air traffic rights in regard to companies established in the other contracting state but owned by non-nationals of that state.
13. See *Commission v. United Kingdom*, note 2, Paras. 33 and 51, respectively.
14. See Braedon Clark, "The Limitation on Benefits Clause Under an Open Sky", *European Taxation* 1 (2003), p. 24 and Michael Lang and Pasquale Pistone, *The EU and Third Countries: Direct Taxation* (Vienna: Linde, 2007), p. 37.
15. See Advocate General Tizzano's Opinion, note 11, Para. 131.

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treaties with EU law. In fact, the nationality clauses work in a very similar manner to the LOB clauses in tax treaties between Member States and the United States. On the other hand, in this particular situation, there is nothing in the tax field that prevents the application of such reasoning to an LOB case. Indeed, it comes as a surprise that, despite the above, the ECJ, in its *ACT GLO* decision (and the Advocate General in his Opinion[16] in that case), did not mention the *Open Skies* decisions at all.[17]

3. The *ACT GLO* Case – A Missed Opportunity?

3.1. The *ACT GLO* decision

To date, the *ACT GLO* case is the only case where the ECJ was directly asked to determine the compatibility of LOB clauses in tax treaties with EU law, by way of a reference for a preliminary ruling from the High Court of Justice of England and Wales, Chancery Division.

The main purpose of the ACT system put in place by the United Kingdom was the avoidance of economic double taxation.[18] At the relevant time, the United Kingdom relieved economic double taxation of dividends through an imputation system.[19]

In *ACT GLO*, the issue arose because, under that system, the United Kingdom would only grant the ACT credit where dividends were paid to resident shareholders or to non-resident shareholders covered by a tax treaty under which such a credit was also granted. This meant, from the claimants' perspective, that the United Kingdom was treating resident shareholders and non-resident shareholders not covered by a tax treaty that provided for a tax credit, differently. Moreover, the claimants argued that this difference in treatment was discriminatory and, as such, was prohibited by the TFEU, namely Art. 49, since it represented a breach of the freedom of establishment.[20]

Notwithstanding this argument, the ECJ decided that the imputation system applied by the United Kingdom was legitimate and did not infringe the fundamental freedoms as described in the TFEU and shaped by the ECJ in its case law.

As for the LOB issue in the decision, both the ECJ and the Advocate General rapidly dismissed the issue. In six paragraphs,[21] the Advocate General expresses the opinion that, "it is not possible to compare the situation of non-residents covered by a DTC and those not covered by that DTC [...]". In its decision, the ECJ also ends up answering this question in the same manner, but supplements its answer with a brief explanation of the arguments supporting its view.[22]

In Para. 86 of the *ACT GLO* judgment, the ECJ states that:

> [...] the terms under which the DTCs provide for a tax credit for non-resident companies which receive dividends from a resident company vary depending not only on the particular characteristics of the national tax regimes concerned, but also on when the DTCs were negotiated and the extent of the issues on which the Member States concerned managed to reach agreement.

In doing so, the ECJ was referring to its previous decision in the *D.*[23] case where it rejected the existence of a most-favoured nation (MFN) principle within the European Union based on the argument that residents of two different Member States are not in the same position as regards a tax treaty entered into by one of the Member States with a third Member State.

Following its reasoning in *D.*, the ECJ took the view that tax treaties, "are inherently intended to apply only to persons resident in the two Member States." Accordingly, there seems to be, "no reason to extend that credit to persons resident in a third Member State".[24]

As Osterweil concludes, the ECJ seems to accord with the interpretation that:

> [...] in a cross-border situation, discrimination between two EU residents may be allowed as long as DTC language authorizes an EU Member State to treat foreign persons more favourably than those not covered by a tax treaty.[25]

In the author's view, the total absence of reference to the *Open Skies* decisions and the comparison with the MFN principle make it impossible to draw any conclusions from the *ACT GLO* case as to the compatibility of LOB clauses with EU law.

3.2. LOB clauses and the MFN principle

As was explained in 3.1., the ECJ, in its *ACT GLO* decision, implicitly compared the mechanisms of an LOB clause to those of an MFN clause. Although the ECJ never stated it explicitly, such a conclusion can be derived from the fact that (1) the question referred to the ECJ specifically raised the issue of the compatibility of LOB clauses with EU law and (2) the fact that the ECJ, in answering that question, used the same line of reasoning put forward in the *D.* case where an MFN clause was clearly at issue. In order to ascertain comparability, the ECJ compared a non-resident with another non-resi-

16. Advocate General Geelhoed's Opinion, 23 February 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue.*
17. See also Lang and Pistone, note 14, p. 37. In a similar manner see Eric Osterweil, "Are LOB Provisions in Double Tax Conventions Contrary to EC Treaty Freedoms?", 18 *EC Tax Review* 5 (2009), p. 241, where he states that the "Open Skies cases may impact upon DTC issues to the extent that they set forth the principle that obligations under the EC Treaty may take precedence over treaty obligations contracted by Member States with third countries".
18. See Advocate General Geelhoed's Opinion, note 16, Para. 6. See also Juanita Bezzina et al., "The 2005 Leiden Forum on Recent and Pending Direct Taxation Cases Before the European Court of Justice", 34 *Intertax* 4 (2006), p. 199.
19. For a brief description of the methods used to relieve economic double taxation, in particular, the imputation system used by the United Kingdom, see note 16, Para. 9 et seq.
20. As consistently happens, both the ECJ and the Advocate General in his Opinion addressed the issue of which fundamental freedom was at stake in the relevant situation, but concluded that the distinction was irrelevant and ended up focusing only on the freedom of establishment.
21. See Advocate General Geelhoed's Opinion, note 16, Paras. 97 to 102.
22. *ACT GLO*, note 3, Para. 83 et seq.
23. ECJ, 5 July 2005, Case C-376/03 *D. v. Inspecteur van deBelastingdienst/Particulieren/Ondernemingen buitenland te Heerlen.*
24. See Osterweil, note 17, p. 245. See also *D.*, note 23, Para. 61.
25. See Osterweil, note 17, p. 245.

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dent, instead of comparing a non-resident with a resident as it typically does.

From the author's point of view, there are several important differences between LOB and MFN clauses that should have justified a different analysis in the *ACT GLO* case.[26] Again, it is submitted that the ECJ should have referred to the *Open Skies* cases instead of the *D.* case.

The MFN principle has its origins outside tax law. It is indeed a well-known principle in the area of trade law, and is one of the guiding principles of the General Agreement on Tariffs and Trade (hereinafter referred to as 'GATT'). Under such a principle:

> [...] any advantage, favour, privilege or immunity granted by a Member to any product originating in or destined for any other country must be accorded immediately and unconditionally regarding that product to all other contracting parties.[27]

In a purely EU context, MFN clauses would be inimical to the logic of a tax treaty network. For that reason, MFN clauses are not a typical feature of tax treaties, which are bilateral in nature.

As Zester[28] correctly points out, LOB clauses have a restrictive effect on taxpayer rights since their only purpose is to deny benefits to persons that do not meet certain tests, while MFN clauses, if adopted in a tax treaty, would provide a benefit for the taxpayers in that it would make access to those benefits easier, namely by allowing nationals/residents of non-contracting states to benefit from the advantages that would, otherwise, not have been at the taxpayer's disposal.

In the author's view, this is a simple, but very important, argument since it demonstrates that the two provisions pursue completely different, if not opposite, goals. Using the same principles in interpreting these provisions seems paradoxical, to say the least.

Along the same line, a reference should be made to Pistone's opinion who, in discussing MFN clauses, states that the, "ACT GLO case undoubtedly implies a separate problem of compatibility of LOB clauses with the right of establishment".[29]

Even if there is some interaction between these two devices, as Zester points out,[30] the fact remains that (1) they have different purposes in that LOB clauses are aimed at the prevention of treaty shopping while MFN clauses are aimed at facilitation of trade, (2) they function in different manners in that the former restricts treaty entitlement and the latter expands it through the granting of the same benefits and (3) they pose different issues in that the former compares home state residents with host state residents and the latter compares residents of two different host states (two non-residents of different states).

3.3. Did the ECJ get it right?

The ECJ's decision in the *ACT GLO* case could have been a landmark decision, as it could have finally provided clear guidance on the issue of the compatibility of LOB clauses with EU law. In the author's opinion, the ECJ was right in determining that there was no discrimination.[31] However, this decision had nothing to do with the ECJ's answer to question 1 c), wherein it was directly asked to address the LOB issue.[32] The author believes that the ECJ's decision would have been the same (or should have been the same) had there been no LOB issue in the case.

In fact, it is not the LOB feature of the case that avoids (or creates) a discriminatory situation. It could not be, since an LOB clause only restricts entitlement to treaty benefits. Accordingly, it would not be a suitable instrument to overcome a situation of discrimination. In this case, the existence of an LOB clause was immaterial, since the solution for this issue resided in the national legislation, namely in the ACT system.

On the other hand, the ECJ's answer to question 1 c) appears to be obscure and confusing, leading to the conclusion that the ECJ did not understand either the question asked, the facts given or the legal issue at stake.[33]

O'Shea,[34] taking a different point of view, is of the opinion that the ECJ did not have to mention the *Open Skies* cases at any stage since those cases concerned a 'nationality clause' while the LOB issue concerns a 'residence clause'. This would be enough to render such a reference completely irrelevant.

The author disagrees. On the one hand, in tax matters, residence, rather than nationality, is normally the connecting factor used by a state to define its tax jurisdiction. On the other hand, the use of residence as a connecting factor is also apt to generate (indirect) discrimination based on nationality.[35]

A different view would be to consider that the ECJ relied on its judgment in *D.* for the sole purpose of making it clear that tax treaties cannot be extended to entities resident in non-contracting states and that two non-residents (one resident in a contracting state and the other

26. Following similar reasoning, see Patrick Plansky and Hermann Schneeweiss, "Limitation on Benefits: From the US Model 2006 to the *ACT Group Litigation*", 35 *Intertax* 8/9 (2007), p. 492 and Alexander Greter, "Limitation on benefits clauses and European Community law: legitimacy and consequences", 9 *EC Tax Journal* 3 (2008), p. 11.
27. See Anitza Zester, "Can the MFN Principle Influence the Use of Limitation on Benefits Clauses in Tax Treaties?", 34 *Intertax* 3 (2006), p. 144.
28. See Zester, note 27, p. 143.
29. Pasquale Pistone, "Test Claimants in Class IV of the ACT Group Litigation: Limitation-Of-Benefits Clauses Are Clearly Different from Most-Favoured-Nation Clauses", *British Tax Review* 4 (2007), p. 364.
30. See Zester, note 27, p. 149.
31. The decision of the ECJ in respect of the system used by the United Kingdom to relieve economic double taxation seems to be correct and in accordance with the principles laid down by the ECJ in its previous case law.
32. See Renata Fontana and Ramona Piscopo, "Conference: Recent and Pending Cases at the ECJ on Direct Taxation, 15-17 February 2007, Vienna", 35 *Intertax* 10 (2007), p. 586.
33. See Pasquale Pistone, "Tax Treaties and the Internal Market in the New European Scenario", 35 *Intertax* 2 (2007), p. 79.
34. Tom O'Shea, "Limitation on Benefit (LoB) clauses and the EU (part II)", *International Tax Report* (November 2008), p. 2.
35. See Mason, note 9, p. 83 where the author observes that, "[a]s the ECJ has observed on countless occasions, nonresidence is a suspect criterion upon which to deny tax benefits to taxpayers similarly situated to residents, since residence tends to overlap substantially with nationality."

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resident in a non-contracting state) are not in the same situation.

The author is of the opinion that the ECJ misunderstood the legal issue at hand. The ECJ wrongly focused its attention on the company owning the entity that was claiming the tax credit.[36] However, the focus should have been on the entity claiming the benefits of the treaty. In relation to that entity (the Dutch entity controlled by German residents), no MFN issues arise since it was a resident of the Member State (Netherlands) that had entered into the relevant tax treaty with the United Kingdom. The ECJ was dragged into the MFN issue because it focused its attention on the controlling company while that company was only mentioned as an additional requirement for the Dutch entity to be entitled (or not) to the benefits of the tax treaty entered into by its own country. The company under scrutiny was the controlled company and not the controlling company.

This position explains the fact that the ECJ did not refer at all to the *Open Skies* cases in *ACT GLO*. In fact, if the ECJ perceived the issue as an MFN issue, the correct reasoning would have been to resort to the *D.* decision, which is the ECJ's landmark decision on that issue. Likewise, had the question, in fact, involved an MFN issue, it would not make sense at all for the ECJ to base its reasoning on the *Open Skies* cases. Also, had the ECJ properly understood the LOB issue, in the author's view, it would have focused on the *Open Skies* cases rather than on the *D.* case, since this would reflect a correct understanding of the matter.[37]

3.4. Why is reference to the *ACT GLO* case not sufficient?

With the *ACT GLO* case, the ECJ could have settled the LOB issue, as it did in respect of the MFN issue in the *D.* case. As stated above, the author's understanding is that the *ACT GLO* case did not, however, settle this issue. Following this line of reasoning, the landmark cases in this area are still the *Open Skies* cases and a decision of the ECJ on the compatibility of LOB clauses with EU law is still absent.

Accordingly, it is important to provide an answer to the question of whether LOB clauses are compatible with EU law. It is indisputable that LOB clauses are an internationally accepted tax practice in the field of tax treaties to tackle abusive schemes, in particular treaty shopping. The OECD itself supports this conclusion in the Commentaries to the OECD Model Tax Convention (OECD Model) by suggesting that contracting states include an LOB provision and by providing a proposal for the wording of such a clause. The ECJ, in *Gilly*,[38] recognized that the OECD, through the OECD Model, sets the trends and internationally accepted practices in the field of tax treaties. In the words of the ECJ, "nor, in the allocation of fiscal jurisdiction, is it unreasonable for the Member States to base their agreements on international practice and the model convention drawn up by the OECD".[39] On the other hand, as the Advocate General expressed in his Opinion delivered in the *Lankhorst-Hohorst* case in respect of thin capitalization rules, the fact that those:

> [...] rules supposedly comply with Article 9 of the OECD model convention does not, in my view, alter the position. Indeed, assuming that such compliance were established, it must still be pointed out that the fact that the rules are consistent with the provisions of the OECD model convention does not also mean that they comply with Article 43 EC. Neither the provisions nor the objectives of the OECD model convention, on the one hand, or of the EC Treaty, on the other, are in fact the same.[40]

The author is of the opinion that the argument put forward in *Gilly* is not valid regarding the use of LOB clauses, as the ECJ was only referring to the allocation of fiscal jurisdiction and that attention should be given to the Opinion of the Advocate General in *Lankhorst-Hohorst*. However, a clear and definitive answer by the ECJ on the issue would be highly desirable.

Conversely, in *Cadbury Schweppes*, the ECJ ends up determining that, as long as a structure has economic substance, it is immaterial if it is tax-driven or if it has a real business purpose behind it. In the words of Osterweil, in that decision, "the ECJ concluded that the UK CFC legislation went too far in favouring anti-abuse as opposed to freedom of establishment".[41]

To the extent that the compatibility of anti-abuse provisions with EU law has always been an issue, this also applies in regard to LOB clauses. However, these clauses may pose particularly interesting problems due to their complex structure.

Finally, the *Saint-Gobain* decision may also play a role here as the ECJ recognized the right of permanent establishments (PEs) owned (and thus controlled) by non-residents to be granted the same treatment as nationals of that Member State (the Member State of establishment). It seems that an *a maiore ad minus* argument can be made even though in *Saint-Gobain* the ECJ required that national treatment be applied, not treaty entitlement, to the entity claiming benefits. If the ECJ recognized that a non-resident controlled by another non-resident could not suffer worse treatment by the Member State of establishment why would it not extend this argument to the situation of a resident company controlled by a non-resident? Again, a clear answer from the ECJ would be vital for a proper functioning of the single market.

4. LOB Clauses Step by Step

4.1. The publicly traded test

Despite the fact that LOB clauses may vary from treaty to treaty, typically, the first test, as regards the entitlement of

36. See *ACT GLO*, note 3, Para. 90.
37. See Pistone, note 33, p. 79.
38. ECJ, 12 May 1998, Case C-336/96, *Mr and Mrs Robert Gilly v. Directeur des services fiscaux du Bas-Rhin*.
39. See *Gilly*, note 38, Para. 31.
40. Advocate General Mischo's Opinion, 26 September 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*.
41. See Osterweil, note 17, p. 243.

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a company to the benefits of the treaty,[42] is the 'publicly traded test'. Putting it simply, it requires that the shares of the company claiming the benefits of the treaty be traded in a particular (or group of) stock exchange(s). This test usually includes both a direct publicly traded test, as well as an indirect publicly traded test. All but one of the tax treaties between the Member States and the United States that include an LOB clause include this kind of test. The sole exception is Cyprus, with a tax treaty that dates back to the 1980s.[43] Despite some differences in wording, the clauses in the above tax treaties are fairly similar.

In the author's view, such a requirement amounts to indirect discrimination (both in regard to the freedom of establishment and the free movement of capital) on grounds of nationality so long as, typically, stocks traded on a stock exchange are mainly those of companies that are incorporated in that state. This means that a company, in order to benefit from the application of the tax treaty, has to have its shares traded on a stock exchange, and such stock exchange cannot just be any stock exchange located in any of the Member States.

The indirect publicly traded test is also of little help. If the shareholding is lower than what is established in the LOB clause, the test will not be met. Moreover, the shareholders need to be resident in one of the contracting states.

In order to avoid these inconveniences, some Member States expand the list of recognized stock exchanges to include (1) stock exchanges in neighbouring countries, (2) well-known stock exchanges or (3) a recognized stock exchange as agreed upon by the competent authorities of the Member States. Even though this last provision can, technically, be used to cover all stock exchanges in the European Union it is, nevertheless, subject to the competent authorities' agreement. The problems that can be raised in this context will be analysed in 4.6.

Moreover, the fact that companies controlled by resident individuals are always entitled to treaty benefits, while other companies need to have publicly traded shares, also seems to be a point of concern when assessing compatibility with EU law.

4.2. The ownership/base erosion test

This is, in practice, the most commonly used test, since it is present in all tax treaties entered into between Member States and the United States that do have an LOB clause and is the only test in the LOB clause in the Cyprus–United States tax treaty.

According to such a provision, a resident of one of the contracting states will be entitled to treaty benefits if more than an agreed percentage of its share capital is owned, directly or indirectly, by residents of the same contracting state who are themselves entitled to the benefits of the tax treaty (the ownership test) and if the majority of the company's gross income is not paid to persons that are not resident in any of the contracting states giving rise to a right of deduction for the company paying such income (the base erosion requirement).

The ownership requirement seems, prima facie, to amount to indirect discrimination on grounds of nationality and thus clearly violates Arts. 49 and 63 of the TFEU. The fact that the LOB test refers to residence is of no importance. A company incorporated in Belgium and controlled by Belgian shareholders is not in a different position as compared to another company incorporated in Belgium but controlled by Spanish shareholders. The access to the tax treaty would be denied simply because a Spanish national decides to exercise its freedom of establishment in its purest form.

In a non-tax case relating to fishing quotas and registration of vessels, the ECJ had already had an opportunity to make a statement on similar ownership requirements and found them to be contrary to the tax treaty.[44] This alone would be enough to strike down this provision as incompatible with EU law.

However, the second requirement of this provision should be analysed. It is apparent that the purpose of the base erosion requirement is to counteract abusive structures. One could argue that the fact that the income flows through the entity sets off the 'abusive structure alarm' since deductions are being used to reduce the income in one jurisdiction in favour of a resident in another jurisdiction, which is commonly known as income stripping.[45]

However, at the level of the European Union that can hardly justify a discriminatory situation. The ECJ has long taken the position that loss of tax revenue is not a justification for a provision giving rise to discrimination.[46]

In fact, in *Lankhorst-Hohorst*,[47] a case relating to sub-capitalization where, as in this case, a deduction for interest payments made to foreign entities was disallowed while it was allowed in a purely domestic situation, the ECJ was more than willing to find that such a denial was contrary to the freedom of establishment.

42. As regards individuals, LOB clauses pose no compatibility issues since every resident individual is entitled to the benefits of the tax treaty. Moreover, the analysis will also not include the issue of the treaty entitlement of contracting states, political subdivisions or local authorities, as these are also not excluded from treaty benefits by the LOB clause. See Art. 22(2) (a) and (b) of the US Model.
43. It should be noted that, as regards LOB clauses, the Cyprus–United States tax treaty is the least sophisticated of all.
44. See ECJ, 25 July 1991, Case C-221/89, *The Queen v. Secretary of State for Transport, ex parte Factortame Ltd and others*, Para. 30.
45. See David H. Rosenbloom, "Limiting Treaty Benefits: Base Erosion, Intermediate Owners and Equivalent Beneficiaries", 58 *Tax Notes International* 8 (2010), p. 650.
46. See, inter alia, ECJ, 16 July 1998, Case C-264/96, *Imperial Chemical Industries (ICI) v. Kenneth Hall Colmer)*, Para. 28, *Saint-Gobain*, note 7, Para. 50; ECJ, 6 June 2000, Case C-35/98*Staatssecretaris van Financiën v. B.G.M. Verkooijen*, Para. 59 and ECJ, 8 March 2001, Joined Cases C-397/98 and 410/98 *Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd v. Commissioners of Inland Revenue and HM Attorney General*, Para. 59.
47. See ECJ, 12 December 2002, Case C-324/00 *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*.

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4.3. The active trade or business test

The active trade or business test is another popular test that may be used in designing an LOB clause. Among the treaties entered into between Member States and the United States, only the tax treaty with Cyprus does not include this test.

The 2004 Protocol to the Netherlands–United States tax treaty has a considerably recent active trade or business test. Under this test, a company that does not qualify under the other tests in the LOB clause may still have access to the benefits of the treaty if it conducts an active trade or business and the income is derived in connection with, or is incidental to, that trade or business.

As Borrego mentions, these tests, "would effectively force an enterprise to incorporate a company in all EC States in which it operates, and not only in the state in which it resides [...]".[48] This means that the test prevents the granting of treaty benefits where the income is derived in connection with a business carried on in another Member State, namely through a PE.

It follows from the ECJ case law that such a requirement is not compatible with the freedom of establishment. In *Segers*[49] the ECJ states that the freedom of establishment:

> [...] requires only that the companies be formed in accordance with the law of a Member State and have their registered office, central administration or principal place of business within the Community. Provided that those requirements are satisfied, the fact that the company conducts its business through an agency, branch or subsidiary solely in another state is immaterial.

Following this same line of reasoning, in *Centros*,[50] the ECJ stated:

> [...] that it is immaterial that the company was formed in the first Member State only for the purpose of establishing itself in the second, where its main, or indeed entire, business is to be conducted.

The active trade or business test in LOB clauses has the same effect, requiring a company incorporated in a Member State to conduct its business in that Member State to the prejudice of other Member States. The ECJ, however, in interpreting the freedom of establishment, is fairly emphatic that it does not require that the business (or part of it) necessarily be carried out in the Member State of establishment (such a requirement would clearly be against the objectives and the functioning of the single market) so long as there is an effective establishment and not just an artificial structure.

In addition to the above, in particular, with respect to the second part of the test, this provision incorporates an irrebuttable presumption of treaty shopping when it focuses on the level of economic involvement in the residence state as compared to the source state. As stated in *Cadbury Schweppes*,[51] such presumptions are not in accordance with EU law unless they solely cover 'wholly artificial arrangements'.[52]

Notwithstanding these problems, it is recognized that this test is still the most flexible of the tests typically incorporated in an LOB clause. The fact that it makes reference to the business carried on in the Member State, and to the connection of the items of income with that business, demonstrates that it takes a similar approach to (1) that developed by the ECJ in construing the concept of 'freedom of establishment' and (2) the test contained in beneficial ownership clauses.

Although these two features may make the test more flexible and closer to compliance with EU law, it is not enough since the test requires the business to be carried on in the Member State of establishment. Moreover, the various and strict conditions that need to be met in order for this test to be applicable render it less flexible than it may seem, which is also likely to collide with the ECJ case law on the concept of establishment, as well as the cases on abuse of law, in the sense that it does not leave much room for real economic activities that do not meet this test to benefit from the treaty.

4.4. The headquarters test

The headquarters test is the least popular test among those typically included in LOB clauses (only the tax treaties between the United States and Austria, Belgium and the Netherlands incorporate such a feature).

Take, for example, the situation of a multinational company with its headquarters in one of the Member States, and a subsidiary in Austria. Assume that such an Austrian subsidiary holds a participation in a US company. When dividends are paid, the Austrian subsidiary would apply for a reduction of the 30% statutory US withholding rate to the 5% rate under Art. 10 of the Austria–United States tax treaty.

Under this test it would also not be possible for the Austrian company to gain access to the benefits of the treaty since the subsidiary is not the headquarters of the multinational company.

As submitted earlier in respect of other tests, this is, prima facie, in breach of the Member States' obligation of compliance with EU law and the fundamental freedoms.

All companies that are not the headquarters of a multinational group but that have been incorporated in a Member State by such headquarters in another Member State in exercising the fundamental freedom of establishment, will be denied tax treaty benefits under such a provision.

One could argue that this provision only refers to the activity carried on rather than to the state of residence of the shareholders. Following this line of reasoning, the

48. See Félix Alberto Vega Borrego, *Limitation on Benefits Clauses in Double Taxation Conventions* (London: Kluwer Law International, 2006), p. 252.
49. ECJ, 10 July 1986, Case 79/85, *D. H. M. Segers v. Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen*, Para. 16.
50. ECJ, 9 March 1999, Case C-212/97, *Centros Ltd v. Erhvervs- og Selskabsstyrelsen*, Para. 17.
51. ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Para. 51.
52. See *Cadbury Schweppes*, note 51, Para. 68.

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issue, if any, could fall to another level, namely it could be viewed as a State aid issue since benefits are only granted to a particular type of activity. It is, however, submitted that this test could also hinder the freedom of establishment in that it creates a disincentive to group structures and to establishment in other Member States through secondary establishments.

4.5. The derivative benefits test

The derivative benefits test represents the biggest challenge in terms of assessing the compatibility of LOB clauses with EU law. It is a considerably recent concept[53] in that the first LOB clause containing a derivative benefits provision is contained in the Ireland–United States tax treaty signed on 28 July 1997. In any event, most derivative benefits provisions were put in place, either through re-negotiation of the tax treaty or amending protocols, in the last decade.

This recent trend in tax treaty negotiation between Member States and the United States is due to the fact that "the European Court of Justice has interpreted such nondiscrimination principles extremely broadly".[54] This triggered the need for a different approach to the inclusion of LOB clauses.

In general, this kind of provision works by granting the benefits of the tax treaty to resident entities that are otherwise not entitled to such benefits because they do not meet any of the above tests, if they are owned by equivalent beneficiaries.[55,56]

As to the ownership requirement, our previous comments in 4.2. should be reproduced here. In respect of the base erosion test in the derivative benefits provision, it poses the same issues as the base erosion test previously analysed in 4.2. Accordingly, the same comments apply.

Taking the United Kingdom–United States tax treaty as an example, in order for a shareholding company to qualify as an equivalent beneficiary, there has to be a tax treaty between its Member State of residence and the United States. In addition, the said company must qualify for all the benefits of such a tax treaty or, by analogy, the benefits of the United Kingdom–United States tax treaty under Art. 23 thereof.

In *Gottardo*, a case involving social security contributions, the ECJ required that Italy extend benefits equivalent to those available under its social security treaty with Switzerland to a French resident.[57] In the author's opinion, a situation that falls under the derivative benefits test poses similar issues to those analysed in *Gottardo* and should, therefore, justify a similar reasoning.

Additionally, in respect of passive income, tax treaty protection will only be granted to the subsidiary if the withholding tax rate in the Parent-United States treaty is at least as low as the one provided in the Subsidiary-United States tax treaty.

If, in *Cadbury Schweppes*, the ECJ allowed a structure that was aimed at benefiting from a lower corporate income tax rate, why would it not allow, under the same conditions, a structure put in place to benefit from a lower withholding tax rate on dividends received?

Another issue with this test is that it fails to answer what would happen if the derivative benefits provision did not apply with respect to the applicable withholding rate. Is the statutory rate applicable (30% in the case of the United States) or the minimum withholding rate in the tax treaty between the shareholder state and the United States?[58]

For all of the above reasons, the author believes that the derivative benefits test is also incompatible with EU law.[59] However, it should be recognized that this new trend in the negotiation of LOB clauses represents an effort to make such clauses compatible with EU law, despite the ECJ's decision in the *ACT GLO* case.[60]

4.6. Competent authority agreement

Obtaining a competent authority agreement is more of an administrative method of granting treaty entitlement and not an actual test imposed on companies claiming tax treaty benefits.

This method is a last resort for entities that could not qualify under any of the previously analysed tests. It is typically the last method set forth in an LOB clause. Out of all the tax treaties entered into between Member States and the United States that have an LOB clause, only the tax treaty with Cyprus does not contain a competent authority agreement provision.

It can be concluded from an analysis of the various tax treaties that (1) the decision to grant tax treaty entitlement is a decision of the competent authority of the source state, (2) it is a discretionary decision in that there are no specific criteria for granting the decision[61] and, sometimes, (3) it requires the agreement of the competent authority of the residence state.[62]

53. Only Belgium, Bulgaria, Denmark, Finland, France, Germany, Ireland, Luxembourg, the Netherlands, Sweden and the United Kingdom have such a provision in their tax treaties.
54. Michael J. Miller and Mark Stone, "The Evolution of Limitation On Benefits, Beneficial Ownership, and Similar Rules: Recent Trends and Future Possibilities", 37 *Tax Management International Journal* 12 (2008), at footnote 23. See also Osterweil, note 17, p. 239.
55. Even though not all tax treaties incorporate the expression 'equivalent beneficiaries' in the wording of the derivative benefits provision, they are all based on such a concept. For an example of a tax treaty that does incorporate that expression, see Art. 23 (3) (a) of the United Kingdom–United States tax treaty. For an example of a treaty with a derivative benefits test that does not include such an expression, see Art. 23 (5) (a) (i) of the Ireland–United States tax treaty.
56. In this respect, see Mason, note 9, p. 78.
57. See Mason, note 9, p. 88.
58. See Ruth Mason, "When Derivative Benefits Provisions Don't Apply", 43 *Tax Notes International* 7 (2006), pp. 565-566 for a discussion on this issue.
59. See, for a contrary opinion, Osterweil, note 17, p. 246.
60. See Osterweil, note 17, p. 247.
61. Even in regard to the extended provision in the protocol to the Germany–United States tax treaty, only general guidance is given on what grounds should justify the concession of treaty benefits. See Rosenbloom, note 45, p. 649.
62. See Art. 23(4) of the Latvia–United States tax treaty for an example of a provision where agreement of the competent authority of the residence state is not required.

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The problems associated with these kinds of clauses are obvious and have been pointed out by the ECJ on numerous occasions.[63] It is now clear that such provisions are not an effective solution, in an EU context, to the incompatibility issues posed by the objective tests used in LOB clauses.[64]

5. A Look into the Future

5.1. Incompatibility of LOB clauses

Based on the analysis in the article to this point, some conclusions can be drawn in respect of the compatibility of LOB clauses with EU law. An ECJ decision on this issue, however, would have an enormous impact, in particular if the ECJ were to conclude that LOB clauses, in fact, are incompatible with EU law.

The author believes that LOB clauses pose several problems in regard to compatibility with EU law. In fact, none of the LOB clauses analysed above were fully compliant with EU law, as all of the tests in these tax treaties raise compatibility issues that cannot be resolved through any of the provisions in the LOB clauses.

In order to avoid this conflict, Craig seems to suggest that Member States carve out from tax treaties measures to avoid tax planning and incorporate them into their domestic legislation.[65] Even though the merits of this proposal can be appreciated, the author seriously doubts that this would be a good solution to the problem. First, changing the source of discrimination would not likely make a difference. The ECJ is more than willing to bring down consolidated international tax practices incorporated by Member States into their legislation. Additionally, even if this were an effective solution, it would only take care of the issue from an EU perspective. The main proponent of LOB clauses, however, is the United States. Even if Member States could take unilateral measures to combat treaty shopping, this would probably not be satisfactory from a US perspective.

A further problem is that if one of the provisions of an LOB clause fails the compatibility test, with the result that it would not be applied,[66] this would give rise to a possible situation of discrimination since the company claiming the benefits of the treaty would be required to resort to one of the subsequent tests in a way that would hinder or makes less attractive the exercise of the basic freedoms.[67]

Considering that the ECJ, in *Cadbury Schweppes*, endorsed a tax planning structure that was solely based on tax considerations and in *Saint-Gobain* required tax treaty benefits to be extended to a non-resident entity because it had exercised its freedom of (secondary) establishment through a permanent PE, there is no reason that the ECJ would not allow treaty shopping within the European Union.[68] The arguments that can be made in this respect are similar to the arguments made in *Saint-Gobain* and that decision of the ECJ is, now, undisputed.

Going back to the origins of the ECJ case law in respect of fundamental freedoms it should be recalled that,"[...] a bilateral agreement which reserves the scholarships in question for nationals of the two MS which are the parties to the agreement cannot prevent the application of the principle of equality of treatment between national and Community workers established in the territory of one of those two MS"[69] and that "the rights conferred by Article 52 of the Treaty are unconditional and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State".[70]

5.2. Accepting a restriction

In accordance with the structure followed by the ECJ in its case law, a complete analysis of this issue would not be complete without considering the possibility of justifications put forward by the Member States.[71] Once the ECJ determines that a situation is discriminatory it goes on to consider the arguments advanced by the Member States (if any) to justify the measure at stake. Moreover, if it considers that the justification is to be accepted it then applies the proportionality test.[72] In order to qualify under the proportionality test, the measure has to be proportional *stricto sensu*, in the sense that it should not impose an obligation on the taxpayer that largely exceeds the benefits of the measure; it has to be adequate, in the sense that it has to be suitable to attain its objectives; and it must be necessary, in the sense that no less restrictive measure could have been adopted for the same purpose.

This article does not consider the argument raised by the Member States in *Open Skies*, which is that the discrimination arose due to the conduct of a third country not bound by EU law, because the ECJ was correct in considering that the discrimination arose by virtue of the tax treaties negotiated by the Member States rather than a specific action of the United States. Also, the author considers that such an argument is more of an argument against the existence of discrimination than a justification for such discriminatory treatment.

63. ECJ, 28 June 1977, Case 11/77, *Richard Hugh Patrick v. Ministre des affaires culturelles*, Para. 15; *Factortame*, note 44, Para. 38 and ECJ, 13 July 2000, Case C-160/99, *Commission of the European Communities v. French Republic*, Para. 23.
64. See also Adam Craig, "Open Your Eyes: What the "Open Skies" Cases Could Mean for the US Tax Treaties with the EU Member States", *Bulletin for International Fiscal Documentation* 2 (2003), p. 73 and see Borrego, note 48, p. 256.
65. See Craig, note 64, p. 74.
66. See *Cadbury Schweppes*, note 51, Para. 75.
67. See Christiana HJI Panayi, "Open Skies for European Tax?", *British Tax Review* 3 (2003), p. 198.
68. See Pasquale Pistone, note 29, p. 364.
69. ECJ, 27 September 1988, Case 235/87, *Annunziata Matteucci v. Communauté française of Belgium and Commissariat général aux relations internationales of the Communauté française of Belgium*, Para. 23.
70. *Commission v. France*, note 6, Para. 26.
71. See Borrego, note 48, p. 257.
72. See Axel Cordewener, Georg Kofler and Servaas van Thiel, "The Clash Between European Freedoms and National Direct Tax Law: Public Interest Defences Availabe to Member States", 46 *Common Market Law Review* 6 (2009), p. 1951.

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With the above in mind, the most important argument in this respect would be that the LOB clause is aimed at preventing abuse. In Paras. 33 and 34 of its decision in *Diamantis*,[73] the ECJ stated that Community law cannot be relied on for abusive or fraudulent ends. Accordingly, anti-abuse measures are not, per se, contrary to EU law, namely the freedom of establishment, and can be used by Member States in order to prevent benefits from being granted in circumstances where abusive transactions have been put in place.[74]

In its case law relating to abusive transactions in regard to direct tax matters, the ECJ found abusive structures to be those that represent 'wholly artificial arrangements'.[75] Accordingly, national measures (including tax treaty provisions) that are justified on the grounds of abuse of law can only target wholly artificial arrangements. If the requirements of the provision also target other situations where there is economic substance, then the justification does not meet the proportionality test.[76]

The fact that LOB clauses are based on objective tests is exactly what creates the harshness and strictness that the ECJ has (on numerous occasions) objected to in its case law on the grounds that such tests are not compatible with the functioning of the single market.

Another argument that would certainly be raised by Member States is that if LOB clauses were not allowed, that would affect the equilibrium and reciprocity that forms the foundation of all bilateral treaties and that bilateral treaties are only effective amongst the parties to the treaty and thus only the parties (or its residents) should get the benefits of those treaties.

This argument, precisely, was raised by the defendant Member State(s?) in Para. 80 of the *ACT GLO* case. Surprisingly, the ECJ acceded to that argument and recalled its judgment in the *D.* case wherein it held that tax treaty benefits are not to be extended to non-resident entities.

Without commenting on the *D.* decision, it is the author's understanding that such an argument should not be accepted as a justification in cases involving LOB clauses due to the fact that the entity claiming the benefits is not the non-resident shareholder but, rather, the resident entity. The discrimination, however, arises because tax treaty benefits are denied to a company that was set up pursuant to the exercise of the freedom of establishment based solely on the fact that it has a foreign shareholder. In fact, it is hard to understand why the ECJ obliged a Member State to extend the benefits of a tax treaty to an entity resident in a state that did not have a tax treaty with the former state, as it did in *Saint-Gobain*, but decided not to do so in a situation involving a resident entity that happened to be owned by a non-resident, as it did in the *ACT GLO* case.[77] Despite the fact that these two cases involved two different perspectives (state of establishment, on the one hand, and state of source, on the other), it is submitted that the ECJ was right in *Saint-Gobain* and that the same rationale should apply to a decision involving LOB clauses. Accordingly, such a justification should not be accepted.

Another justification that Member States normally resort to is that not accepting a given measure will result in a loss of tax revenue. This argument does not require much explanation as the ECJ has consistently held that this is not a justification that should be accepted in a single market context since it cannot be regarded as a matter of overriding general interest.[78]

Accordingly, it is the author's conclusion that such a provision is not justified.[79]

5.3. Consequences for the Member States

As Mason[80] acknowledges, the effects of such a decision by the ECJ would be huge since it would impact the very core of the concerns of both the European Union and the United States.

At the external level, Art. 351 of the TFEU allows Member States to keep in place measures in agreements (such as tax treaties) entered into before 1 January 1958 or before the accession date for acceding states, even if those measures are incompatible with the EU treaties. Nonetheless, Member States are required to take all appropriate measures to eliminate existing incompatibilities. Accordingly, Member States are always required to comply with EU law, the difference being that acceding states are granted a period of time to renegotiate their agreements so that they comply with EU law. The mere fact that the other contracting state (here, the United States) does not want to change a given provision is not sufficient to prove that the Member State did all it could to eliminate the incompatibility. If, however, such renegotiation is not possible, it is submitted that the Member State must terminate the agreement.

Tax treaties concluded by a Member State after its accession date would fall outside the scope of Art. 351.[81] Despite the fact that, due to hierarchy, EU law prevails over tax treaties, Art. 46(1) of the Vienna Convention[82] prevents Member States from invoking EU law in order to escape obligations under (tax) treaties unless the treaties manifestly violate internal rules of fundamental impor-

73. ECJ, 23 March 2000, Case C-373/97, *Dionisios Diamantis v. Elliniko Dimosio (Greek State) and Organismos Ikonomikis Anasinkrotisis Epikhiriseon AE (OAE)*.
74. See, Mason, note 9, p. 85.
75. See *Cadbury Schweppes*, note 51, Para. 51.
76. See Servaas van Thiel, "The Direct Income Tax Case Law of the European Court of Justice: Past Trends and Future Developments", 62 *Tax Law Review* 143, p. 175.
77. See Mason, note 9, p. 88. For a similar argument, see Cordewener, Kofler and Van Thiel, note 72, at p. 1986 and Arnaud de Graaf, "Designing an anti-treaty shopping provision: an alternative approach", 17 *EC Tax Review* 1 (2008), p.15.
78. See, for example, *Saint-Gobain*, note 7, Para. 50 and *ICI*, note 46, Para. 28. For a further analysis of the argument see Cordewener, Kofler and Van Thiel, note 72, pp. 1957-1963.
79. See also Craig, note 64, p. 72 and HJI Panayi, note 67, p. 147.
80. See Mason, note 9, p. 86.
81. See Georg W. Kofler, "European Taxation Under an 'Open Sky': LoB Clauses in Tax Treaties Between the U.S. and EU Member States", 35 *Tax Notes International* 1 (2004), p. 78.
82. Vienna Convention on the Law of Treaties, available at http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf.

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tance. Even though this is a solution put forward by some authors[83] it is unlikely that such a justification would be accepted by the United States. It follows from the discussions in the tax literature on the issue that such incompatibility is not objectively evident, i.e. that there is no manifest violation as required by the Vienna Convention.

If a tax treaty has to be terminated by a Member State, it is submitted that the whole tax treaty should be terminated, not only the LOB clause. On the one hand, it is highly unlikely that the United States would agree to keep a tax treaty in force that did not contain an LOB clause, as this would mean granting benefits that it sought to be protected from by such a clause. Moreover, in light of the applicable law, Art. 44 of the Vienna Convention sets forth that the right of a party to denounce a treaty cannot be exercised in respect of only a part of the treaty unless otherwise stated or agreed upon.

From an internal perspective, some authors suggest that the *Francovich* principle of state liability should apply in this respect.[84] Pursuant to Para. 40 of *Francovich*,[85] three conditions must be met in order for a Member State to be held liable for a breach of EU law, as follows:

> The first of those conditions is that the result prescribed by the directive should entail the grant of rights to individuals. The second condition is that it should be possible to identify the content of those rights on the basis of the provisions of the directive. Finally, the third condition is the existence of a causal link between the breach of the State's obligation and the loss and damage suffered by the injured parties.

The ECJ restated these conditions in *FII*.[86] Even though it is arguable that the rule is intended to confer rights on individuals and that there is a direct causal link between the damage and the obligation imposed on Member States to comply with EU law, it would be difficult to conclude, in regard to LOB clauses, that the breach of such an obligation is serious enough to find that the Member State has manifestly and gravely disregarded the limits on its discretion.[87] In view of the extensive debate on the issue of the compatibility of LOB clauses with EU law it would not be easy to assert that the breach is serious.

5.4. Possible solutions

Assuming that it can be concluded that Member States are not allowed to insert LOB clauses into their tax treaties with the United States, with the result that Member States should be required to terminate such treaties in order to comply with EU law, the final step would be to analyse the possible solutions that Member States have at their disposal in order to comply with EU law, bearing in mind that tax treaties are an important tool for the development of international trade and that Member States want to maintain such tax treaties.

The solution that is frequently referred to as the best solution in regard to this issue is a convention sponsored by the Commission that would affect US-EU relations.[88] Such a multilateral treaty would have the merit of eliminating discrepancies in the tax treaties between Member States and the United States. In this scenario, LOB clauses would no longer be needed to combat treaty shopping by residents of other Member States. Such a treaty could keep in place the LOB clause in regard to residents of third states, but it would no longer make sense to keep LOB clauses in place against residents of other Member States since there would no longer be an incentive to treaty shop. In fact, treaty conditions would be the same in regard to all the states.[89]

Even though this would probably be the best solution, it would also be the most difficult to achieve. In fact, it would be almost impossible to achieve consensus in regard to a tax treaty meeting the demands of all 27 Member States, plus the three EEA States and a non-Member State, such as the United States.[90]

Another possibility would be to alter the current LOB clause in order to accommodate all of the ECJ's requirements. The issue could be settled by inserting the 'wholly artificial arrangement' concept, as construed by the ECJ, into the active trade or business test in LOB clauses between Member States and the United States. However, it would all come down (again) to treaty negotiation and tax policy. The author believes that this solution would be difficult to implement. In fact, for the United States, the use of LOB clauses is a vital component of their tax policy (as are the fundamental freedoms for Member States) and, thus, they are not likely to surrender such clauses as a result of another country's contingencies. It appears that there are two irreconcilable goals at play: the United States, on the one hand, wants to combat treaty shopping through objective, easier to apply, tests and the European Union, on the other hand, does not want to combat treaty shopping amongst Member States and only allows restrictions on the fundamental freedoms based on abuse if they only target wholly artificial arrangements. Objective tests can hardly be designed to exclusively cover wholly artificial arrangements.

A third solution would be for Member States to compensate taxpayers for the difference between the tax rate applied and the tax rate that would have been applied had the tax treaty benefits been granted. According to this solution, Member States would have to fully credit the US tax.[91]

However, it is easy to anticipate that Member States would not be happy with this solution. The effect on the

83. See Craig, note 64, p. 74.
84. See Kofler, note 81, p. 79, HJI Panayi, note 67, p. 201 and Didier Sepho, "Does the U.K.–U.S. Tax Treaty Conflict With the EC's Freedom of Establishment Principle?", 32 *Tax Notes International* 3 (2003), p. 279.
85. ECJ, 19 November 1991, Joined Cases C-6/90 and C-9/90, *Andrea Francovich and Danila Bonifaci and others v. Italian Republic*.
86. See ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, Para. 209 and the case law cited therein.
87. See *FII GLO*, note 86, Para. 212.
88. See, for all, Mason, note 9, p. 108.
89. See, in support of this view, Pistone, note 8, p. 9.
90. Against this solution, see Klaus Vogel, Daniel Gutmann and Ana Paula Dourado, "Tax treaties between Member States and Third States: 'reciprocity' in bilateral tax treaties and non-discrimination in EC law", 15 *EC Tax Review* 2 (2006), p. 84.
91. See Mason, note 9, p. 86.

tax revenue of some countries could be considerable. Also, an argument could be made that the balance and reciprocity of the treaties could be put at risk and that there would no longer be an incentive to enter into tax treaties. Member States would be unilaterally granting a full credit, which means that their residents would not benefit from the same advantages in the United States. Additionally, even if this unilateral solution would eliminate the effects of the discrimination, the fact is that, from a technical standpoint, the discriminatory measure would continue to exist. Accordingly, the Commission could still bring an infringement procedure to the ECJ against the Member States.

If the United States insists on keeping LOB clauses as they are now, the ECJ will most likely be very cautious in the analysis of the issues discussed herein in an attempt not to compromise. It is possible that the ECJ would prefer to avoid the issue (as it did in *ACT GLO*) or accept a justification on dubious treaty shopping grounds. As this is a sensitive matter, the ECJ may not be as willing to assume a groundbreaking posture as it was in the past.

In our opinion the ECJ should consider that LOB clauses are incompatible with EU law, which should force the United States to withdraw their LOB clauses in tax treaties with Member States and go back to a solution, such as the beneficial ownership test, that is suitable to meet the requirements of the ECJ in abuse matters and can also tackle abusive treaty shopping situations. Regardless, a solution can only be found if any (or both) of the sides involved can be flexible in their demands.

6. Conclusions

Tax treaties between Member States and the United States have, in the last two-three decades, included LOB provisions aimed at combating treaty shopping.

In an EU context, the ECJ has allowed, on different occasions, namely in *Avoir Fiscal* and in *Saint-Gobain*, residents of a Member State to establish themselves in another Member State through a non-resident entity (a PE) and to benefit, in the Member State of establishment, from the same advantages granted to residents, whether such advantages were granted under domestic legislation (*Avoir Fiscal*) or whether they were granted under tax treaties with other countries, including both Member States and non-Member States (*Saint-Gobain*).

Moreover, the ECJ has also explicitly allowed tax driven structures (in *Cadbury Schweppes*) so long as they did not constitute wholly artificial arrangements. Accordingly, as long as there is substance in a structure and it is not a mere 'letterbox' of 'front office', tax reasons may validly be held as a justification for it. This view clearly allows for (within the European Union) a certain degree of jurisdiction shopping. If one considers, additionally, that the ECJ stated in its *Bouanich* decision that tax treaties are part of the national set of rules that have to comply with EU law and that are for the ECJ to assess, in terms of compatibility, it can be said that treaty shopping is also allowed.

If one treaty partner allows (or has to allow) treaty shopping by other Member States' residents and the other fiercely opposes such practices, there is an impasse that is virtually impossible to resolve.

The ECJ is the authority that is in the best position to settle this issue and has already had the opportunity to do so. In its *Open Skies* decisions the ECJ brought down air traffic rights agreements entered into between some Member States and the United States on the basis that they contained provisions that allowed the United States to discriminate against companies owned by nationals of Member States other than the Member State treaty partner. Due to the similarity of those provisions with LOB clauses, many commentators argued, at the time, that LOB clauses were also incompatible with EU law.

Some years later, the ECJ was directly asked to determine the compatibility of LOB clauses with EU law in the *ACT GLO* case. Surprisingly, in answering that question, the ECJ ended up considering that such a clause did not create any discrimination. Even though the author agrees with the ECJ that there was no discrimination in that case, this ruling had nothing to do with the functioning of the LOB clause but, rather, with the domestic legislation of the United Kingdom. In fact, the ECJ's answer to the LOB issue is somewhat intriguing. The ECJ referred to its judgment in *D.* and seemed to compare LOB clauses with the MFN principle. As was previously mentioned, such a comparison seems to be incorrect. In its analysis, the ECJ used, for the comparability test, the non-resident shareholder when it should have used the resident company that was claiming the benefits of the treaty.

After that case many authors considered that the ECJ had settled the issue, as it did in *D.* regarding the MFN issue. However, the history of ECJ case law indicates that the ECJ, initially, is cautious in its analysis of a new issue but turns to groundbreaking decisions at a latter stage in what can be seen as a 'cyclical pattern'.[92]

The author believes that the ECJ did not settle the issue, and that another case needs to be argued on this issue. In any event, following the leading principles laid down by the ECJ in its case law it is apparent that LOB clauses pose several compatibility issues and cannot be accepted at the present stage of the EU project.

92. See Van Thiel, note 76, p. 179.

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