*CFE ECJ Task Force**

Opinion Statement ECJ-TF 1/2018 on the Compatibility of Limitation-on-Benefits Clauses with the EU Fundamental Freedoms

This Opinion Statement was prepared by the CFE ECJ Task Force and concerns the compatibility of limitation-on-benefits (LoB) clauses with the EU fundamental freedoms, based on decisions of the European Court of Justice (ECJ). The context of this statement is the Commission's infringement procedure against the Netherlands with regard to the LoB clause in the Japan-Netherlands Income Tax Treaty (2010) and the inclusion of a simplified optional LoB clause in the BEPS Multilateral Instrument.

1. Background and Issues

The focus of this Opinion Statement (OS) is limitation-on-benefits (LoB) clauses, i.e. tax treaty clauses that restrict the benefits of a tax treaty to certain residents of a contracting state, such as those controlled by a resident of a non-contracting state (notably foreign-controlled corporations).

Such clauses aim to counter "treaty shopping". This typically involves the establishment of an intermediate holding company in a state having tax treaties with both the state of residence of the investor, and with that of the state of source of the profits, which together provide a more favourable regime than if the investor had received the profit directly.

The focus of this OS is on the compatibility of such clauses with the EU fundamental freedoms, taking into account statements made by the ECJ in its tax and non-tax case law.

Although the compatibility of LoB clauses with EU fundamental freedoms has long been under scrutiny, especially as to their restrictive effect on the exercise of the right of establishment within the internal market,[1] the issue has recently come under the spotlight in connection with the BEPS Action 6 recommendation – endorsed by the G20 on 15-16 November 2015 – to the effect that states should include LoB clauses in their tax treaties.[2] The BEPS Multilateral Instrument,[3] signed in Paris on 7 June 2017, also includes a simplified LoB provision as a tool to counter treaty shopping. Further, the 2017 Update to the OECD Model[4] contains an LoB clause in new article 29.

In addition, from the perspective of EU law, the request of the EU Commission of 19 November 2015[5] for the Netherlands to amend the LoB clause contained in article 21 of the Japan-Netherlands Income Tax Treaty (2010),[6] which includes stock-exchange and derivative-benefits tests,

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Unlike the usual format of Opinion Statements (OS) of the CFE ECJ Task Force, this one does not address the issue on the basis of a single decision, but rather by taking into account the various relevant statements made by the ECJ. This OS addresses the potential authority of previous decisions on LOB clauses, the implications that different reasoning of the Court may have on the exercise of fundamental freedoms and the apparent conflict between ECJ decisions.

1. *See*, for example, para. 19 of the Commission's working document, EC Law and Tax Treaties, TAXUD E1/FR DOC (05) 2306 (9 June 2005). *See*, inter alia, A. Martín Jiménez, *EC Law and Clauses on Limitation of Benefits in Treaties with the U.S. after Maastricht and the U.S.-Netherlands Tax Treaty*, 4 EC Tax Rev. 2, p. 81 et seq. (1995); G. Kofler, *European Taxation Under an 'Open Sky': LoB Clauses in Tax Treaties Between the U.S. and EU Member States*, Tax Notes Intl., p. 46 et seq. (5 July 2004); P. 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 Rev. 4, pp. 363-365 (2007); P. Pistone, F. Cannas & R. Julien, *Can the Derivative Benefits Provision and the Competent Authority Discretionary Relief Provision Render the OECD-Proposed Limitation on Benefits Clause Compatible with EU Fundamental Freedoms?*, in *Base Erosion and Profit Shifting (BEPS) – The Proposals to Revise the OECD Model Convention* pp. 165-218 (M. Lang et al. eds., Linde 2016), who hold that they are incompatible with fundamental freedoms; for the opposite view, *see* A.P. Dourado, *Portugal*, in *The EU and Third Countries: Direct Taxation* pp. 499-536 (M. Lang & P. Pistone eds., Kluwer Law International 2007); E. Kemmeren, *Where is EU Law in the OECD BEPS Discussion?*, 23 EC Tax Rev. 4, pp. 191-192 (2014); T. O'Shea, *Limitation on Benefits (LoB) clauses and the EU Part I*, International Tax Report pp. 1-8 (Oct. 2008). Such issues were also discussed within the framework of a conference at the EU Commission on 5 July 2005, the details of which are available at http://ec.europa.eu/taxation_customs/taxation/company_tax/double_taxation_conventions/workshop/index_en.htm; F.Debelva et al., *LOB Clauses and EU-Law Compatibility: A Debate Revived by BEPS?*, 24 EC Tax Rev. 3, pp. 132-143 (2015), have taken the middle ground, concluding that LoB clauses, if targeted at wholly artificial arrangements, can ultimately be regarded as compatible with EU fundamental freedoms.
2. *See* OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD.
3. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (24 Nov. 2016), Treaties IBFD.
4. *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Models IBFD.
5. *See* the section "Taxation: Commission asks the Netherlands to amend the Limitation on Benefits clause in the Dutch-Japanese Tax Treaty for the Avoidance of Double Taxation" in European Commission, Fact Sheet – November infringements package: key decisions, MEMO/15/6006 (19 Nov. 2015), available at http://europa.eu/rapid/press-release_MEMO-15-6006_en.htm.
6. *Convention between the Kingdom of the Netherlands and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (25 Aug. 2010), Treaties IBFD.

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also brings new momentum to the issue. The Commission announced:

> The European Commission asked the Netherlands today to amend the Limitation on Benefits (LOB) clause in the Dutch-Japanese Tax Treaty for the Avoidance of Double Taxation, which entered into force on 1 January 2012. The Commission believes that, on the basis of previous cases such as C-55/00 *Gottardo* and C-466/98 *Open Skies*, a Member State concluding a treaty with a third country cannot agree better treatment for companies held by shareholders resident in its own territory, than for comparable companies held by shareholders who are resident elsewhere in the EU/EEA. Similarly, it cannot agree better conditions for companies traded on its own stock exchange than for companies traded on stock exchanges elsewhere in the EU/EEA. However, under the current terms of the LOB clause, some entities are excluded from the benefits of the tax treaty. This means that they suffer higher withholding taxes on dividends, interest and royalties received from Japan than similar companies with Dutch shareholders or whose shares are listed and traded on "recognised stock exchanges", which include certain EU and even third-country stock exchanges. The Commission's request takes the form of a reasoned opinion. In the absence of a satisfactory response within two months, the Commission may refer the Netherlands to the Court of Justice of EU.

The key point is that the Commission holds the view that, on the basis of previous (non-tax) ECJ case law – such as *Gottardo* (Case C-55/00)[7] and the *Open Skies* decisions[8] – "a Member State concluding a treaty with a third country cannot agree better treatment for companies held by shareholders resident in its own territory, than for comparable companies held by shareholders who are resident elsewhere in the EU/EEA".[9]

As of the date of drafting this OS, the procedure is still listed as pending, i.e. there have been no public developments. This is surprising considering that 2.5 years have passed since the European Commission sent its initial request to the Netherlands.

Tax treaty practice is not uniform. LoB clauses contain a range of features. This OS does not aim to provide a comprehensive overview of all such clauses. It analyses the character and operation of some common elements of LoB clauses (section 2.), with a view to determining, in light of relevant precedents, the extent to which they create procedural and/or substantive restrictions and if so, whether such restrictions can be justified by the need to counter abusive practices, or other grounds of public importance, including the requirements of the principle of proportionality (sections 3. and 4.). The OS will then discuss the possible repercussions for EU Member States if LoB clauses are declared incompatible with the EU fundamental freedoms (section 5.).

As stated, the focus of this statement is on the fundamental freedoms. It does not consider LoB clauses from any other perspective, including that of State aid, the Parent-Subsidiary Directive (2011/96),[10] or any wider policy considerations. As for LoB clauses, this Statement focuses on "ownership test" clauses and also refers to "discretionary benefit" clauses. It does not address the anti-abuse clauses in some treaties that are described as limitation-on-benefits clauses, but in fact have different structural features, and more closely resemble treaty GAARs. This type of clause is sometimes included in the bilateral treaties of OECD countries, in particular Mexico, and more often in treaties concluded by developing countries. The EU law issues of compatibility raised by such LoB clauses are substantially different and are better addressed separately, together with the problems presented by GAARs.

2. The Structural Features, Types and Effects of Clauses

LOB clauses were originally designed by the United States in the 20th century. The purpose was to counter treaty shopping without the need for the lengthy procedures required by GAARs.

LoB clauses, therefore, raise similar issues to all specific anti-avoidance rules (SAARs), which determine effects on an automatic or quasi-automatic basis.

The worldwide spread of such clauses over the past two decades has been significant. In addition, clauses have been agreed that go beyond the boundaries of US tax treaty practice. These developments appear due to the effectiveness of LoB clauses to counter treaty shopping.[11]

An "ownership test" LoB clause, as described in section 1., is generally triggered where a resident (A) of a non-contracting state (B) may indirectly become entitled to a more favourable tax treaty with the source state of income by controlling a resident of a state (B), that has concluded the more favourable tax treaty with the source state (C).

7. IT: ECJ, 15 Jan. 2002, Case C-55/00, *Elide Gottardo v. Istituto nazionale della previdenza sociale (INPS)*, EU:C:2002:16, ECJ Case Law IBFD.
8. UK: ECJ, 5 Nov. 2002, Case C-466/98, *Commission of the European Communities v. United Kingdom of Great Britain and Northern Ireland*, EU:C:2002:624, ECJ Case Law IBFD; DK: ECJ, 5 Nov. 2002, Case C-467/98, *Commission of the European Communities v. Kingdom of Denmark*, EU:C:2002:625, ECJ Case Law IBFD; SE: ECJ, 5 Nov. 2002, Case C-468/98, *Commission of the European Communities v. Kingdom of Sweden*, EU:C:2002:626, ECJ Case Law IBFD; BE: ECJ, 5 Nov. 2002, Case C-471/98, *Commission of the European Communities v. Kingdom of Belgium*, EU:C:2002:628, ECJ Case Law IBFD; LU: ECJ, 5 Nov. 2002, Case C-472/98, *Commission of the European Communities v. Grand Duchy of Luxembourg*, EU:C:2002:629, ECJ Case Law IBFD; AT: ECJ, 5 Nov. 2002, Case C-475/98, *Commission of the European Communities v. Republic of Austria*, EU:C:2002:630, ECJ Case Law IBFD; and DE: ECJ, 5 Nov. 2002, Case C-476/98, *Commission of the European Communities v. Federal Republic of Germany*, EU:C:2002:631, ECJ Case Law IBFD.
9. *See supra* n. 5.
10. Council Directive 2011/96/EU of 30 November 2011 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, OJ L 345/8 (2011), EU Law IBFD.
11. Pistone, Cannas & Julien, *supra* n. 1, indicate that at least the following treaties between EU Member States include a type of LoB clause: Belgium-Estonia, effective 1 Jan. 2004, art. 28; Belgium-Latvia, effective 1 Jan. 2004, art. 29; Belgium-Lithuania, effective 1 Jan. 2004, art. 29; Belgium-Poland, Protocol to the 2001 Treaty, signed in 2014, not yet effective, art. 28A; Estonia-Italy, effective 1 Jan. 2001, art. 28; Estonia-Latvia, effective 1 Jan. 2002, art. 29; Estonia-Lithuania, effective 1 Jan. 2006, art. 30; Estonia-Portugal, effective 1 Jan. 2005, art. 27; Germany-Malta, effective 1 Jan. 2002, art. 27; Germany-Spain, art. 28, effective 1 Jan. 2013; Italy-Latvia, effective 1 Jan. 2009, art. 30; Italy-Lithuania, effective 1 Jan. 2000, art. 30; Latvia-Lithuania, effective 1 Jan. 1995, art. 30; Latvia-Portugal, effective 1 Jan. 2004, art. 28; Lithuania-Portugal, effective 1 Jan. 2004, art. 28; Malta-Portugal, effective 1 Jan. 2003, art. 27; Malta-Slovenia, effective 1 Jan. 2004, art. 27; Malta-Spain, effective 1 Jan. 2007, art. 27; Poland-Slovakia, effective 1 Jan. 1996 and protocol effective 1 Jan. 2015, art. 28A; and Poland-Sweden, effective 1 Jan. 2006, art. 27.

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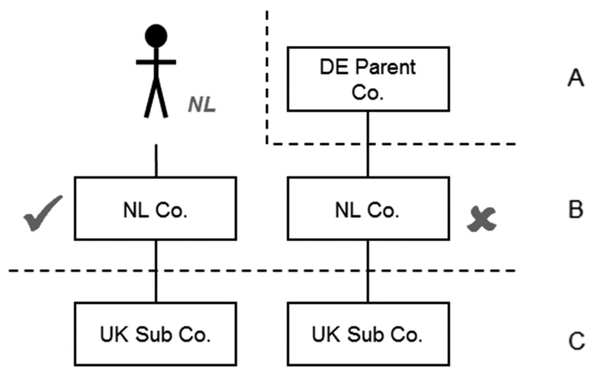
- To counter "treaty shopping" fully, a typical LoB clause contains a number of objective tests.
- Under the "ownership test", entities at least 50% of whose shares are held by other qualified persons generally qualify for treaty benefits; however, that "ownership test" is generally supplemented by a "base erosion test" that disqualifies entities that pay 50% or more of their gross income to persons who are not qualified persons.
- The LoB clause recommended by the OECD, in the framework of the BEPS Project, treats certain publicly-listed entities and their affiliates and other entities that meet certain ownership requirements as qualified entities.
- In addition, LoB clauses usually contain (i) an escape clause that provides treaty benefits in respect of certain income of a person that is not a qualified person if the person is engaged in the active conduct of a business in its state of residence and the income is derived in connection with, or is incidental to, that business, and (ii) a "derivative benefits" test, i.e. a provision that provides treaty benefits to a person that is not a qualified person if at least a specified proportion of that entity is owned by certain persons entitled to equivalent benefits, i.e. signalling that "treaty shopping" is not involved, as the owners of the entity could derive the treaty benefits themselves without "interposing" the entity.
- Finally, even if treaty benefits would be denied under the objective tests of an LoB clause, a "subjective clause" can allow the competent authority of a contracting state to grant certain treaty benefits to a person where benefits would otherwise be denied.

The operation of the "ownership test" of a typical LoB clause of this sort was addressed in the 2006 *ACT Group Litigation* (Case C-374/04) decision.[12] There, under the Netherlands-United Kingdom Income Tax Treaty (2008),[13] certain benefits granted by source State C (i.e. the United Kingdom) were denied to the recipient of a dividend in State B (i.e. a Netherlands entity) under the treaty's LoB clause because its sole shareholder was resident in a third Member State A (i.e. Germany) – *see* Diagram 1.

To summarize, an "ownership test" LoB clause can deprive taxpayers resident in State B, who are controlled by non-residents, of entitlement to the benefits of tax treaties that they would otherwise enjoy along with other residents of State B. Further, this deprivation is applied without a case-by-case analysis.

For the purposes of this OS, a restriction could arise from such a clause in two ways. First, as the taxpayer resident in

Diagram 1: The denial of treaty benefits under the Germany-United Kingdom Tax Treaty in ACT Group Litigation



State B is deprived of his entitlement to the tax treaty benefits available to other residents, a substantive obstacle to the exercise of fundamental freedoms may arise. Second, even where the taxpayer is ultimately able to obtain the treaty benefit, the LoB clause can also be a source of procedural obstacle to the exercise of fundamental freedoms, taking into account the complexity of such clauses and the potential difficulties in proving the facts required to preserve entitlement to tax treaty benefits. Either could amount to a restriction, given settled ECJ case law that protects the timely and effective exercise of rights granted by EU law.

As noted, an alternative to the "ownership test" LoB clause is the "discretionary relief" LoB clause. This has a different structure, and allows, to some extent, for a case-by-case analysis. This type of LoB clause, however, gives tax authorities wide discretion to decide whether, and the conditions under which, a resident controlled by a non-resident can preserve its entitlement to tax treaty benefits. Accordingly, this type of LoB clause may restrict EU fundamental freedoms by representing a procedural obstacle, as the exercise of the freedom is left to the discretionary powers of the tax authorities of the EU Member State of residence.[14] This is not analysed further herein.

Issues of compatibility of the "ownership test" type clause, including the other tests frequently associated with such a clause, are analysed in the following sections in light of existing ECJ case law on overt and covert restrictions on the exercise of fundamental freedoms within the internal market. Section 3. focuses on residence state (i.e. State B) cases (for example, *Gottardo* and the *Open Skies* and *Factortame II* cases),[15] in which the Court rejected the compatibility of nationality clauses with the right of establishment. Section 4. considers the sole occasion on which the Court considered an LoB clause from the perspective of the source state, i.e. *ACT Group Litigation*.

12. UK: ECJ, 12 Dec. 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, EU:C:2006:773, ECJ Case Law IBFD.
13. *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains* (26 Sept. 2008), Treaties IBFD.
14. It is settled ECJ case law that the exercise of freedoms may not be left to the discretionary powers of a Member State (*see* UK: ECJ, 12 Dec. 2006, Case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v. Commissioners of Inland Revenue*, ECLI:EU:C:2006:774, para. 212, ECJ Case Law IBFD).
15. *The Queen v. Secretary of State for Transport, ex parte Factortame Ltd and others* (C-221/89).

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3. From the Perspective of the Residence State B

The EU Commission infringement procedure against the Netherlands considers this scenario. It addresses the treatment, under the Japan-Netherlands Income Tax Treaty (2010), of an entity, resident in the Netherlands, receiving income from Japan.

In its request of 19 November 2015, the EU Commission pointed out that the ECJ had already rejected, in the *Gottardo* and *Open Skies* decisions, the compatibility of clauses in agreements with third countries that provide for different treatment depending on nationality.

Under EU law, the need for effective protection of the exercise of free movement of persons may oblige a Member State unilaterally to extend the benefits its nationals receive under tax treaties signed with a third country to nationals of other EU Member States in its territory.[16] The fact that non-Member States are not obliged to reciprocate or to comply with EU law does not change this.

In particular, the *Gottardo* case[17] addressed a situation of overt discrimination (under the Italy-Switzerland Social Security Agreement (1962))[18] affecting an individual who was a national of neither contracting state (but of France) who, having exercised her freedom to work in Italy, claimed against the Italian state her right to enjoy the same treatment for social security purposes to which Italian nationals were entitled under the social security agreement with Switzerland.

Furthermore, in the *Open Skies* decisions, the Court reached similar conclusions in the context of air-traffic routes between the United States and EU Member States.[19] The nationality clauses contained in the bilateral air traffic agreements of several EU Member States with the United States share the common feature of limiting traffic rights on flights between the contracting states solely to national companies of such states.

The interpretation of nationality clauses in the *Gottardo* and *Open Skies* cases reflects settled case law of the Court prohibiting overt and covert restrictions that are liable to deter the exercise of fundamental freedoms. There is no reason to think that the tax context should lead to a different outcome, and in addition the Court explicitly quoted *Saint-Gobain* (Case C-307/97)[20] in *Open Skies*.[21]

From the perspective of the residence State B, the *Gottardo* and *Open Skies* decisions demonstrate that the impact of LoB clauses on the exercise of the right of establishment is to be determined simply by looking at whether the application of such clauses has a restrictive effect. Insofar as the LoB clause provides for a different treatment depending on ownership, it is likely to dissuade EU nationals from exercising the right of establishment into State B.

The starting point for assessing the existence of such a restriction is a comparison between (i) a resident entity of EU Member State B, which is controlled by a non-resident shareholder (who is a resident of EU Member State A), and (ii) another resident company of EU Member State B. Since, in these circumstances, all such companies are subject to the fiscal sovereignty of EU Member State B in the same way and thus liable to pay income taxes under the same conditions, applying the reasoning of the *Saint-Gobain* decision, there is no doubt that the conditions for the resident company controlled by a non-resident shareholder to enjoy national treatment have been met.[22]

Accordingly, any less favourable tax treatment connected with the mere fact that a resident of EU Member State B is controlled by a non-resident entity, which is a resident of EU Member State A, is likely to constitute a restriction on the right of establishment within the internal market.

As the ECJ case law essentially takes the same approach regardless of the applicable fundamental freedom, LoB clauses could also give rise to a restriction in respect of other freedoms, such as the free movement of capital and services.

This means that insofar as the LoB clause may have an impact on the exercise of a freedom within the internal market (i.e. between EU Member State A and EU Member State B), it makes no difference if the source state (i.e. State C) is an EU Member State or a third country.

However, it may make a difference if State A is instead a third country. In such a scenario, there can only be an infringement if the LoB clause affects the exercise of free movement of capital. This is particularly the case where benefits are restricted because of non-controlling shareholders in State A.

Insofar as there is a restriction, what needs to be examined is whether it may be justified in light of the need to counter abusive practices, which is an accepted justification under settled ECJ case law.[23]

In assessing how this justification operates in practice, one should bear in mind that EU Member States do not have *carte blanche* as to its implementation, but should comply with the framework determined by the overall principles of EU law. More specifically, broad international consensus within the framework of the BEPS Project as to a sort

16. This type of issue was addressed already in DE: ECJ, 21 Sept. 1999, Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, EU:C:1999:438. ECJ Case Law IBFD.
17. *Gottardo* (C-55/00).
18. *Convention between the Swiss Confederation and the Italian Republic on Social Security* (14 Dec. 1962) (unofficial translation), Treaties IBFD.
19. *Commission v. United Kingdom* (C-466/98); *Commission v. Denmark* (C-467/98); *Commission v. Sweden* (C-468/98); *Commission v. Belgium* (C-471/98); *Commission v. Luxembourg* (C-472/98); *Commission v. Austria* (C-475/98); and *Commission v. Germany* (C-476/98).
20. *Saint-Gobain* (C-307/97).
21. *See Commission v. United Kingdom* (C-466/98), paras. 45 and 46, wherein the Court also quoted para. 32 of the *Gottardo* (C-55/00) decision in addressing the obligation of EU Member States to unilaterally also ensure national treatment in situations involving agreements with third countries.
22. In *Saint-Gobain* (C-307/97), at paras. 47-49, the Court held that it was not permissible for Member State B to apply worse tax treatment to a permanent establishment in Member State B of a company incorporated and established in Member State A, than to a company incorporated and resident in State B. This finding was based on the fact that Member State B essentially taxed the two in the same way.
23. *See* A. Garcia Prats et al., *EU Report*, in *Anti-avoidance measures of general nature and scope – GAAR and other rules* (IFA Cahiers vol. 103a, 2018), Online Books IBFD.

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of abuse that should be countered is not per se the source of a justification. A restriction is only permitted where there is abuse as established by the case law of the Court.

The Court has routinely stated that the need to counter abusive practices requires a case-by-case analysis, which is indispensable in order for a measure to be suitable to achieve its goal, and proportionate.

These concerns are also not relieved by the "derivative benefits" clauses, whereby treaty residents of another state (for example, State A) who meet appropriate criteria can help satisfy the ownership test. To put it simply, a derivative benefits test entitles a company that is a resident of a contracting state (i.e. State B) but is not entitled to treaty benefits under the basic tests of an LoB provision, to treaty benefits if the beneficial owner of that company (for example, individuals or qualified corporations in State A) would have been entitled to the same benefit (i.e. reduced source taxation in State C) had the income in question flowed directly to that owner.[24] It is, however, obvious that such a "derivative benefits" test merely mitigates, but does not eliminate, the concerns under the fundamental freedoms because such tests rely on the benefits in other tax treaties such that, for example, an LoB clause in a tax treaty that provides for a zero rate will only lead to derivative benefits if the shareholders of the interposed entity would likewise enjoy a zero rate had they received the income directly. In the latter circumstances, derivative benefits clauses do not eliminate possible disproportionate (procedural or substantive) restrictions on the right of establishment.

Finally, issues also arise as to the application of discretionary relief LoB clauses. Such clauses allow for a case-by-case analysis, but their mechanism generates specific problems of compatibility with fundamental freedoms as interpreted by settled direct tax ECJ case law. In particular, this is so when this type of LoB clause is intrinsically linked with the attribution of discretionary powers to tax authorities and disconnected from timely and effective protection of entitlement to the benefits of the tax treaty of the state of the resident subsidiary controlled by a parent company established in a different Member State. This may make the exercise of the right of establishment more difficult in practice (being the source of a procedural restriction), or even provide no certainty as to entitlement to treaty benefits.

4. From the Perspective of Source State C (the *ACT Group Litigation* Case)

Tax-related LoB clauses were considered briefly by the ECJ in the *ACT Group Litigation* case,[25] concerning the Netherlands-United Kingdom Income Tax Treaty (2008). The issue was considered as part of a single reference dealing with several cases, each raising different issues. That meant that the Court had to consider a fairly complex situation, and its decision paid particular attention to other issues, notably entitlement to most-favoured-nation treatment.

In *ACT Group Litigation*, the Court held that the LoB clause at issue did not infringe the freedom of establishment. But the rationale is not clear. To understand this, it is necessary to understand the structure of the decision. The Court addressed issues of most-favoured-nation treatment at paragraphs 78 to 86, and then again at paragraphs 92 to 94. Only paragraphs 89 and 90 unambiguously address the LoB case. Paragraphs 87, 88 and 91 might be directed to either case, or both. The Court argued:

> 88 Thus, the grant of a tax credit to a non-resident company receiving dividends from a resident company, as provided for under a number of DTCs concluded by the United Kingdom, cannot be regarded as a benefit separable from the remainder of those DTCs, but is an integral part of them and contributes to their overall balance (see, to that effect, [ECJ, 5 July 2005, C-376/03, *D*, EU:C:2005:424], paragraph 62).
>
> 89 The same applies to the provisions of the DTCs which make the grant of such a tax credit subject to the condition that the non-resident company is not owned, directly or indirectly, by a company resident in a Member State or a non-member country with which the United Kingdom has concluded a DTC which does not provide for such a tax credit.
>
> 90 Even where such provisions extend to the situation of a company which is not resident in one of the contracting Member States, they apply only to persons resident in one of those Member States and, by contributing to the overall balance of the DTCs in question, are an integral part of them.

Paragraph 90 appears to state that the impact of the treaty on a person "which is not resident in one of the contracting Member States" is to be disregarded. But where it restricts the exercise of a fundamental freedom by that person, this appears to be directly contrary to the analysis in *Gottardo* and *Open Skies*. At least *Open Skies* was cited to the Court, though neither case was referred to in the Opinion or decision. If the Court had intended to overrule these cases, it is reasonable to conclude that it would have addressed them directly.

Accordingly, it is not clear that the relevant conclusions reached by the Court in *ACT Group Litigation* do constitute a precedent endorsing the compatibility of LoB clauses with the EU fundamental freedoms, even from the perspective of source State C.

The question may, in effect, be whether EU source State C is permitted to restrict the exercise of a fundamental freedom from EU State A to EU State B. Taking the example of the freedom of establishment, the wording of the treaty provisions is not clear. The Commission's action with regard to the LoB clause in the Japan-Netherlands Income Tax Treaty (2010) may give the Court a welcome opportunity to clarify its considerations in *ACT Group Litigation*.

24. The idea behind the derivative benefits concept is that treaty benefits pursuant to a tax treaty between two countries should also be available to a company owned by residents of a third country, provided the treaty benefits are no more extensive than those residents would enjoy had they earned the respective income directly rather than through the interposed company. This, in turn, demonstrates that the interposition of an entity in State B does not serve a treaty shopping purpose.
25. *ACT Group Litigation* (C-374/04).

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5. The Possible Repercussions within the Internal Market and in Relations with Third Countries

Against this backdrop, this statement turns to a consideration of the impact of EU law on ownership tests in LoB clauses contained in a treaty between two EU Member States and those contained in treaties between one EU Member State and one non-EU Member State. The two are discussed separately below.

In the former case, subject to any remaining impact of *ACT Group Litigation*, where State A is an EU Member State, both residence State B and source State C would have to interpret an LoB clause so as to restrict its application to cases of abusive practices. This would mean that, within the European Union, LoB clauses would be denied the ability to operate on an automatic or quasi-automatic basis, which has, until now, made them so attractive to tax administrations.

For LoB clauses in treaties with third countries – including those in the Japan-Netherlands Income Tax Treaty (2010) currently under review by the Commission – the consequences may be different, since the third country is not bound by EU law.

In such a scenario, the taxpayer is a resident of Member State B with income from a third country C, who is subject to higher taxation in State C because of it being partly owned by residents of Member State A, with third country C thus denying treaty benefits based on an LoB clause.

This statement now turns its attention to the legal obligations on an EU Member State in relation to LoB clauses if the Court follows the line of reasoning adopted in *Gottardo* and *Open Skies*.

In such a scenario, since the EU Member State involved cannot invoke any justification for the LoB clause in its entirety (the clause would only be effective to the extent of Member State B conducting a case-by-case analysis of the existence of the abusive practice), three key issues arise.

First, EU Member States could no longer include such LoB clauses in future treaties, at least to the extent explained here.

Second, they would also be obliged to renegotiate their treaties with a view to removing the violation of the freedoms.[26] This could be achieved via a treaty change to limit the LoB's effect to cases falling under the ECJ's definition of abuse, abolishing the LoB, or by terminating the treaty. While the first two alternatives appear contradictory to the purpose underlying the initial inclusion of an LoB clause, terminating the treaty would achieve equal treatment only by making the situation worse for most taxpayers and better for none and is thus not desirable from a policy perspective.

Third, an EU Member State B could be obliged to secure national treatment for its residents adversely affected in non-EU contracting State C by the LoB clause, i.e. by neutralizing those disadvantages unilaterally.[27]

Finally, this statement analyses the practical impact of this third issue on a scenario reflecting the pattern of the procedure initiated by the EU Commission on 19 November 2015, to show that it is the least important of the three. This scenario concerns the Netherlands as residence State B of a subsidiary that is controlled by a company residing in a different EU Member State A receiving income from a third country C, here Japan.

In such a scenario, Japan may automatically apply the treaty LoB clause and accordingly refuse to limit the exercise of its taxing rights in respect of income paid to Netherlands subsidiaries not quoted on the Netherlands stock exchange when controlled by non-resident parents, or apply the derivative benefits approach, restricting benefits by reference to the treaty with the country of residence of the parent company. In these circumstances, the Netherlands subsidiary should nonetheless be entitled to national treatment if it proves the genuine exercise of the (right of establishment) in the Netherlands. As a consequence, the Netherlands would be obliged to secure national treatment by means of its domestic law. Since the disadvantage results directly from taxation in Japan, this would have to take the form of relief for taxes levied by Japan. As this might well exceed any tax liability that the subsidiary faces in the Netherlands (by virtue of a participation exemption or otherwise), the question arises whether this would require the Netherlands to neutralize this disadvantage. There seem to be two potential options for doing so: first, based on the fundamental freedoms, with a possible credit, or, second, attempting to recover the cost of such taxes by way of a claim for damages under state liability rules – on the basis that the EU Member State has breached EU law conferring equal treatment on resident taxpayers whether or not controlled by foreign (EU resident) shareholders. The latter option would likely fail due to the restrictive conditions laid down in the *Brasserie du Pêcheur* and *Factortame* cases.[28] In particular, due to the unclear status of legality of LoB clauses due to the case law discussed herein, Member State B's decision to add or accept an LoB clause in its tax treaty with third country C will not likely constitute a "sufficiently serious" breach of EU law. Furthermore, there may be difficulties in proving the existence of a direct causal link between the infringement and the higher tax levied by the third country, as it is uncertain what alternative agreement Member State B could have obtained from the third country C: If the

26. This follows from art. 351(2) of the Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), EU Law IBFD for all bilateral agreements with third states regardless of whether they were concluded prior to or after the Member State's accession to the European Union.

27. Despite art. 351(1) TFEU, this is also true regardless of whether the bilateral agreement predates the Member State's accession to the European Union, since doing so does not affect the Member State's obligations under the agreement.

28. DE: ECJ, 5 Mar. 1996, Joined Cases C-46/93and C-48/93, *Brasserie du Pêcheur SA v. Bundesrepublik Deutschland and The Queen v. Secretary of State for Transport, ex parte: Factortame Ltd and others*, EU:C:1996:79, ECJ Case Law IBFD. Similarly, *FII Group Litigation* (C-446/04), paras 209-218.

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default alternative had been no tax treaty at all, the third country would have levied the same (high) source tax.

6. The Statement

The CFE finds that typical LoB clauses are likely to be incompatible with EU fundamental freedoms, since the different tax treaty regime connected with their application is likely to generate a procedural or substantive restrictive impact on the exercise of the right of establishment within the internal market, which may dissuade EU national individuals and corporations from controlling a subsidiary in a different EU Member State.

Nor can the different specific features of LoB clauses justify such restriction in the absence of the assessment of an actual abusive practice, which settled ECJ case law requires be done on the basis of a case-by-case analysis. In the absence of such an analysis, the CFE submits that it would be hard to reconcile the application of LoB clauses with the requirements of the principle of proportionality within the internal market.

On the basis of such grounds the CFE believes that, at least until the ECJ addresses the compatibility of LoB clauses with the EU fundamental freedoms, EU Member States should take into account their obligations under the principles of the internal market when negotiating LoB clauses in their tax treaties (for example, by defining all EU nationals and corporations as equivalent beneficiaries for the purpose of applying the derivative benefits test). Any possible issue of an effective reaction to treaty shopping could be addressed, on a case-by-case analysis, by means of a PPT clause, in the form recommended also by the EU Commission in its Recommendation C(2016) 271.[29] For the same reasons, EU Member States must also ensure that the application of the existing LoB clauses complies with the internal market.

29. Commission Recommendation (EU) 2016/136 of 28 January 2016 on the implementation of measures against tax treaty abuse (notified under document C(2016) 271), OJ L 25/76 (2016)), EU Law IBFD.

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