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by Georg W. Kofler

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Special Reports

European Taxation Under an 'Open Sky': LoB Clauses in Tax Treaties Between the U.S. and EU Member States

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I. Preface: Limitation on Benefits and Nondiscrimination in EC Law

A. First Overview

Several double taxation treaties between the U.S. and EU member states contain limitation on benefits (LoB) clauses. Generally, those clauses exclude resident corporations from treaty benefits unless they have a sufficiently strong nexus to the contracting state where they claim residence. It has long been questioned whether those provisions are in compliance with the fundamental freedoms of the EC Treaty, since companies whose shareholders are residents of other member states would not qualify under a specific LoB clause in a treaty between the U.S. and a contracting member state. That may be seen as an unjustified hindrance to the freedom of establishment or the free movement of capital.[1] But because EC law can not create obligations for third countries such as the United States, one might — against the backdrop of the *Saint-Gobain* case[2] — hesitate to conclude that the source of a hindrance lies in the mere entering into that type of treaty by the respective member state.[3] However, that very argument is indicated by the recent "open skies" judgments of the European Court of Justice.[4]

[1]*See*, *e.g.*, Thömmes, O., "U.S.-German Tax Treaty Under Examination by the EC Commission," *Intertax* 1990, 605 (605); Troup, E., "Of Limited Benefits: Article 26 of the New U.S./Netherlands Double Tax Treaty Considered," *BTR* 1993, 97 (102 *et seq.*); DeCarlo, J., A.W. Granwell, and S. van Weeghel, "An Overview of the Limitation on Benefits Article of the New Netherlands-U.S. Income Tax Convention," 22 *Tax Mgm't Int'l J.* 271 (279 *et seq.*)

(continued on next column)

Footnote 1 continued

(1993); Hinnekens, L., "Compatibility of Bilateral Tax Treaties with European Community Law — The Rules," *EC Tax Rev.* 1994, 146 (158); Doyle, H., "Is Article 26 of the Netherlands-United States Tax Treaty Compatible With EC Law?" *ET* 1995, 14 (14 *et seq.*); Martín-Jiménez, A.J., "EC Law and Clauses on 'Limitation of Benefits' in Treaties With the U.S. After Maastricht and the U.S.-Netherlands Tax Treaty," *EC Tax Rev.* 1995, 78 (78 *et seq.*); Hinnekens, L., "Compatibility of Bilateral Tax Treaties with European Community Law — Application of the Rules," *EC Tax Rev.* 1995, 202 (226 *et seq.*); Farmer, P., "EC Law and Direct Taxation — Some Thoughts on Recent Issues," *EC Tax J.* 1995/96, 91 (104 *et seq.*); Kaye, T.A., "European Tax Harmonization and the Implications for U.S. Tax Policy," 19 *B. C. Int'l & Comp. L. Rev.* 109 (164 *et seq.*) (1996); Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus*. 165 (165 *et seq.*) (1997); Toifl, G., "Austria," in P. Essers, G. de Bont, and E. Kemmeren, E. (Eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties With EC Law* (1998) 41 (49 *et seq.*); Kemmeren, E., "The Netherlands," in P. Essers, G. de Bont, and E. Kemmeren (Eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties With EC Law* (1998) 125 (146 *et seq.*); *see also, e.g.,* Streng, W.P., "'Treaty Shopping': Tax Treaty 'Limitation on Benefits' Issues," 15 *Hous. J. Int'l L. 1* (48) (1992); Bennett, M.C. *et al.*, "A Commentary to the United States-Netherlands Tax Convention," *Intertax* 1993, 165 (196 *et seq.*); Dahlberg, M., "New Tax Treaty Between Sweden and the U.S. Raises Questions About Treaty-Shopping," Intertax 1997, 295 (297 *et seq.*).

[2]ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint- Gobain* — paras. 59, 60; *see also infra* II.D.

[3]In this sense, Van Unnik, D. and M. Boudesteijn, "The New U.S.-Dutch Treaty and the Treaty of Rome," *EC Tax Rev.* 1993, 106 (113 *et seq.*); *cf.* Martín-Jiménez, A.J., "EC Law and Clauses on 'Limitation of Benefits' in Treaties With the U.S. After Maastricht and the U.S.-Netherlands Tax Treaty," *EC Tax Rev.* 1995, 78 (81); Farmer, P., "EC Law and Direct Taxation — Some Thoughts on Recent Issues," *EC Tax J.* 1995/96, 91 (104); Tumpel, M., "Europarechtliche Besteuerungsmaßstäbe für die grenzüberschreitende Organisation und Finanzierung von Unternehmen," in Pelka, J. (Ed.), *Europa- und verfassungsrechtliche Grenzen der Unternehmensbesteuerung* DStJG 23 (2000) 321 (353 *et seq.*).

[4]The open skies cases, which are discussed *infra* II, have again put the focus on the compatibility of LoB clauses with EC Law; *see, e.g.*, Craig, A., "Open Your Eyes: What the 'Open Skies' Cases Could Mean for the U.S. Tax Treaties with the EU Member States," *BIFD* 2003, 63 (63 *et seq.*); Clark, B., "Limitation on Benefits: Changing Forms in the U.S.-U.K. Tax Treaty," *ET* 2003, 97; Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (189 *et seq.*); Sepho, D., "Does the U.K.-U.S. Tax Treaty Conflict With the EC's Freedom of Establishment Principle?" *Tax Notes Int'l,* 20 Oct. 2003, p. 279; Oliver, D.B., "Tax Treaties and the Market-State," 56 *Tax L. Rev.* 587 (599 *et seq.*) (2003).

The issue of whether LoB clauses are in compliance with EC law has been brought to the attention of the European Commission. In 1990 the Commission was asked whether it agrees that LoB provisions contravene the EC Treaty and that all EU residents should be treated equally as qualified shareholders under those clauses. While a final answer is pending, the Commission indicated that it is carrying out a detailed study of the question.[5] However, in 1992 the Ruding Report, a major document on EU tax harmonization, stated that treaty provisions such as LoB clauses "can discriminate against enterprises of other Community countries."[6] In recent years the Commission has put further emphasis on the issue and confirmed in 2001 that it is "certainly true that antiabuse clauses in tax treaties concluded by Member States with third countries should not discriminate against taxpayers in other Member States"; therefore, LoB clauses "concluded by many EU countries with the United States should be examined in this connection."[7] A recent communication paper dated 2003 made the point clear: It announced that particular attention must be paid to the enforcement of the equal treatment principle of the EC Treaty, including, for example, with respect to LoB clauses.[8]

B. Limitation on Benefits in Tax Treaties Between the U.S. and EU Member States

It is well established that an income tax treaty, or, synonymously, a double taxation convention (DTC), is a vehicle for providing treaty benefits to residents of two contracting states and for dividing taxing rights between those states. However, a DTC must establish its personal scope; it must determine who is to be treated as a resident of each contracting state for the purpose of granting treaty benefits. If a DTC were to provide benefits to any resident of a contracting state, putting aside national antiabuse measures, it would permit "treaty shopping," that is, 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 contracting states.[9] Treaty shopping is usually not viewed as encompassing situations in which the third-country resident had substantial reasons for establishing the structure that were unrelated to obtaining treaty benefits. Against that background, and deviating from the OECD model convention,[10] the U.S. began in 1981 to negotiate comprehensive LoB provisions in its DTCs.[11] The U.S. LoBs basically consist of a series of self-executing objective tests, which avoid the fundamental problem of making a subjective determination of the taxpayer's intent.[12] If a resident of one treaty partner fails to meet the LoB provision, it will not be eligible for treaty benefits; in other words, an LoB provision simply limits the personal scope of a DTC.[13]

The United States believes that tax treaties should include provisions that specifically prevent misuse of

[5]Written Question No. 2046/90 by Mr. Gijs de Vries to the Commission of the European Communities, 5. 9. 1990 (91/C 79/47), OJ C 79/28 (25. 3. 1991); *see also* Thömmes, O., "U.S.-German Tax Treaty Under Examination by the EC Commission," *Intertax* 1990, 605 (605).

[6]Commission of the European Communities (Ed.), Report of the Committee of Independent Experts on Company Taxation — Ruding Report (1992) 206.

[7]"Company Taxation in the Internal Market," SEC(2001)1681, 362.

[8]"An Internal Market Without Company Tax Obstacles — Achievements, Ongoing Initiatives and Remaining Challenges," COM(2003)726 final, 11.

[9]*See, e.g.,* Haug, S.M., "The United States Policy of Stringent Anti-Treaty-Shopping Provisions: A Comparative Analysis," 29 *Vand. J. Transnat'l L.* 191 (195 *et seq*., 204) (1996).

[10]However, although the text of the OECD model does not contain expressed antiabuse provisions, the commentaries contain an extensive discussion approving the use of those provisions in tax treaties to limit the ability of third-state residents to obtain treaty benefits. *See, e.g.,* OECD, Commentaries to the Model Tax Convention on Income and on Capital 2000, article 1 para. 7 *et seq*.; *OECD*, Commentaries to the Model Tax Convention on Income and on Capital 2003, article 1 para. 9 *et seq*.; *cf.* Streng, W.P., "'Treaty Shopping': Tax Treaty 'Limitation on Benefits' Issues," 15 *Hous. J. Int'l L.* 1 (28) (1992). The commentaries to the OECD 2003 model convention for the first time contain an example of a detailed LoB provision (which strongly reminds one of the LoB clause in the 1996 U.S. model treaty), giving a guideline to states wishing to address the treaty shopping issue in a comprehensive way; see *OECD*, Commentaries to the Model Tax Convention on Income and on Capital 2003, article 1 para. 20; *cf.* Martín-Jiménez, A.J., "The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries?" *BIFD* 2004, 17 (21).

[11]For a historical overview, see Rosenbloom, H.D., "Tax Treaty Abuse: Policies and Issues," 15 *Law & Pol'y Int'l Bus.* 763 (763 *et seq*.) (1983); Streng, W.P., "The U.S.-Netherlands Income Tax Convention — Historical Evolution of Tax Treaty Policy Issues Including Limitation On Benefits," *BIFD* 1991, 11 (13 *et seq*.); Streng, W.P., "'Treaty Shopping': Tax Treaty 'Limitation on Benefits' Issues," 15 *Hous. J. Int'l L.* 1 (10 *et seq*.) (1992); Berman, D.M. and Hynes, J.L., "Limitation on Benefits Clauses in U.S. Income Tax Treaties," 29 *Tax Mgm't Int'l J.* 692 (697 *et seq*.) (2000). *See also*, for an overview of pre-LoB measures, Grady, K.A., "Income Tax Treaty Shopping: An Overview of Prevention Techniques," 5 *Nw. J. Int'l L. & Bus.* 626 (626 *et seq*.) (1983).

[12]*See, e.g.*, Rasmussen, M. and D.D. Bernhardt, "Denmark: The 'Limitation on Benefits' Provisions in the Tax Treaty With the United States," *ET* 2001, 138 (139).

[13]*See* Van Herksen, M., "Limitation on Benefits and the Competent Authority Determination," *BIFD* 1996, 19 (21); *cf.* Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus.* 165 (172) (1997).

treaties by residents of third countries.[14] Consequently, LoB clauses, although generally not part of European treaty policy, are contained in all recent U.S. income tax treaties with EU member states: The first LoB provision in a treaty between the United States and a (now) EU member state is found in the treaty with Cyprus.[15] The negotiation of more comprehensive LoB clauses started in the late 1980s in the treaties with Germany and Finland,[16] and continued — with ever-increasing complexity and detail — in the treaties from the early 1990s with Spain, the Netherlands,[17] and in the amendment of the treaty with Belgium,[18] and in the treaties concluded in the mid-1990s with the Slovak Republic, the Czech Republic, France, Sweden, Portugal, Luxembourg, Austria, and Ireland.[19] Following that treaty policy, LoB clauses — although much more complex — are included in the recent treaties with Denmark[20] and the U.K.,[21] and in the protocol to the pending with Italy.[22] The LoB clauses in the treaties with some of the new EU member states — Estonia, Latvia, Lithuania, and Slovenia[23] — are, however, broadly based on article 22 of the 1996 U.S. model treaty. Because of the intense negotiation activity in recent years, especially with the new EU member states, only the older treaties with Greece, Hungary, and Poland remain without LoB provisions.[24,25] Finally, it can be noted that there is currently no tax treaty in force between the United States and new member state Malta because that DTC was terminated as of January 1, 1997.[26]

Regarding legal entities other than tax-exempt organizations, the contracting states themselves, or their political subdivisions or local authorities, a typical modern LoB article[27] limits benefits to resident corporations the shares of which are substantially and regularly traded on one or more recognized and specified exchanges, or to qualified subsidiaries of such publicly traded corporations (direct and indirect stock exchange test).[28] Treaty benefits are also available to a resident if a certain percentage of its beneficial ownership is held by qualified residents such as resident individuals, publicly traded companies, or U.S. citizens and less than a certain percentage of the entity's gross income is paid to nonqualified persons in the form of interest, royalties, or other deductible

[14]Treasury Department Technical Explanation of the United States Model Income Tax Convention of September 20, 1996 (article 22), *96 TNI 186-17; see also* M.C. Bennett, "The U.S.-Netherlands Tax Treaty Negotiations: A U.S. Perspective," *BIFD* 1991, 3 (3).

[15]Article 26 Cyprus-United States DTC, signed March 19, 1984.

[16]Article 28 Germany-United States DTC, signed August 29, 1989; article 16 Finland-United States DTC, signed September 21, 1989.

[17]Article 17 Spain-United States DTC, signed February 22, 1990; article 26 Netherlands-United States DTC, signed December 18, 1992. On March 8, 2004, the United States and the Netherlands signed an amending protocol to the Netherlands-United States DTC that provides for major changes in the LoB provision, especially the derivative benefits clause, but it is not in force yet.

[18]Article 12A Belgium-United States DTC, signed July 9, 1970, December 31, 1987.

[19]Article 17 Slovak Republic-United States DTC, signed October 8, 1993; article 17 Czech Republic-United States DTC, signed September 16, 1993; article 30 France-United States DTC, signed August 31, 1994; article 17 Sweden-United States DTC, signed September 1, 1994; article 17 Portugal-United States DTC, signed September 6, 1994; article 24 Luxembourg-United States DTC, signed April 3, 1996; article 16 Austria-United States DTC, signed May 31, 1996; article 23 Ireland-United States DTC, signed July 28, 1997.

[20]Article 22 Denmark-United States DTC, signed August 19, 1999.

[21]Article 23 United Kingdom-United States DTC, signed July 24, 2001.

[22]Article 2 of the protocol to the Italy-United States DTC, signed August 25, 1999 [pending].

[23]Article 22 Estonia-United States DTC, signed January 15, 1998; article 23 Latvia-United States DTC, signed January 15, 1998; article 23 Lithuania-United States DTC, signed January 15, 1998; article 22 Slovenia-United States DTC, signed June 21, 1999.

[24]Greece-United States DTC, signed February 20, 1950; Hungary-United States DTC, signed February 12, 1979; Poland-United States DTC, signed October 8, 1974. It is interesting that the Hungary-United States DTC was the last U.S. treaty to contain no LoB provision; see Berman, D.M. and J.L. Hynes, "Limitation on Benefits Clauses in U.S. Income Tax Treaties," 29 *Tax Mgm't Int'l J.* 692 (697) (2000).

[25]For an overview of the existing treaties between the United States and EU member states, *see* Appendix I, and for an overview of the LoB clauses in treaties between the United States and EU member states, Appendix II.

[26]*See* Treasury Department News Release (RR-717, Nov. 20, 1995) — United States Terminates 1980 Income Tax Treaty With Malta, *95 TNI 230-25*; *see also* the 1995 U.S. Notice of Termination, *96 TNI 71-38*.

[27]As generally contained in treaties or treaty protocols signed after 1988; *see, e.g.*, article 22 of the 1996 U.S. Model Income Tax Convention, *96 TNI 186-16*, and the Treasury Department Technical Explanation of the United States Model Income Tax Convention of September 20, 1996 (article 22), *96 TNI 186- 17*.

[28]Article 22(2)(c) of the 1996 U.S. Model Income Tax Convention (article 22), *96 TNI 186-16*.

payments (ownership and base erosion test).[29, 30] Lastly, a resident entity engaged in an active trade or business in the residence state may seek treaty benefits if its income derived from the other state is derived in connection with or incidental to the business in the residence state (active trade or business test).[31] The assumption underlying each of those tests is that the taxpayer who satisfies the requirements of any of them probably has a real business purpose for the adopted structure or that he has a sufficiently strong nexus to the other contracting state to warrant benefits even in the absence of a business connection, and that the business purpose or connection outweighs any purpose to obtain the benefits of the treaty.[32] Apart from those objective tests, a typical LoB article also contains a subjective clause. That is, benefits may be granted if the competent authority of the member state from which benefits are claimed determines that it is appropriate to provide benefits in that case although none of the objective tests is met.[33]

However, the LoB provisions in existing U.S. treaties are far from homogenous and deviate from the U.S. model conventions because some EU member states have attempted to consider their obligations under the EC Treaty in negotiating and drafting their DTC with the United States.[34] Several treaties, including those with Denmark, France, Ireland, the Netherlands, and the United Kingdom, include substantially more detailed LoB articles to create certain exceptions and safe harbors and, apparently, to reduce the discretion of the tax authorities to take unfavorable positions. Also, some treaties include a headquarters company test[35] or incorporate a so-called derivative benefits concept, whereby third-country treaty residents who meet appropriate criteria can help satisfy the ownership and base erosion test.[36] Other variations include relaxing the base erosion test if deductible payments are made to EU, EEA, or NAFTA residents,[37] considering a trade or business conducted in other EU member states for purposes of the active trade or business test,[38] taking into account EU ownership in the indirect stock exchange test,[39] and considering EU beneficiaries for the qualification of a trust as a qualified resident.[40] It may also be noted that the LoB

[29]The rationale behind the two-prong test is that, because treaty benefits can be indirectly enjoyed not only by equity holders of an entity but also by that entity's various classes of obligees (such as lenders, licensors, service providers, insurers, and reinsurers), simply requiring substantial ownership of the entity by treaty country residents or U.S. citizens will not prevent those benefits from inuring substantially to third-country residents. It is also necessary to require that the entity's deductible payments be made in substantial part to treaty country residents or to U.S. citizens. *See, e.g.,* Treasury Department Technical Explanation of the France-United States DTC (article 30); Treasury Department Technical Explanation of the U.S.-Germany DTC (article 28); *cf.* Schuch, J. and G. Toifl, "Austria: Highlights of the New Tax Treaty With the United States," *ET* 1998, 20 (28); Berman, D.M. and J.L. Hynes, "Limitation on Benefits Clauses in U.S. Income Tax Treaties," 29 *Tax Mgm't Int'l J.* 692 (695) (2000).

[30]Article 22(2)(f) of the 1996 U.S. Model Income Tax Convention (article 22), *96 TNI 186-16*; *cf., e.g.,* Cohen, H.J., L.A. Pollack, and R. Molitor, "Analysis of the New U.S.-Luxembourg Income Tax Treaty," 25 *Tax Mgm't Int'l J.* 403 (412) (1996).

[31]Article 22(3) of the 1996 U.S. Model Income Tax Convention, *96 TNI 186-16.*

[32]Treasury Department Technical Explanation of the United States Model Income Tax Convention of September 20, 1996 (article 22), *96 TNI 186-17*; *cf., e.g.*, Van Herksen, M., Limitation on Benefits and the Competent Authority Determination, BIFD 1996, 19 (22).

[33]Article 22(4) of the 1996 U.S. Model Income Tax Convention, *96 TNI 186-16. See* for a discussion of the subjective clauses and their influence on the compatibility of LoB clauses with EC Law *infra* III.E.

[34]*See* on this background, *e.g.*, DeCarlo, J., A.W. Granwell, and S. van Weeghel, "An Overview of the Limitation on Benefits Article of the New Netherlands-U.S. Income Tax Convention," 22 *Tax Mgm't Int'l J.* 271 (271, 279 *et seq*.) (1993).

[35]*See* article 16(1)(h) Austria-United States DTC; article 30(3) France-United States DTC; article 26(3) Netherlands-United States DTC.

[36]*See* article 22(4) Denmark-United States DTC; article 30(4) France-United States DTC; article 23(5) Ireland-United States DTC; article 24(4) Luxembourg-United States DTC; article 26(4) Netherlands-United States DTC; article 23(3) United Kingdom-United States DTC; *see* also *e.g.,* H.D. Rosenbloom, "Derivative Benefits: Emerging U.S. Treaty Policy," *Intertax* 1994, 83 (83); Cohen, H.J., L.A. Pollack, and R. Molitor, "Analysis of the New U.S.-Luxembourg Income Tax Treaty," 25 *Tax Mgm't Int'l J.* 403 (411) (1996). For a discussion of the derivative benefits concept and its relation to EC law, *see infra* III.D.

[37]*See* article 30(1)(d)(ii) France-United States DTC; article 24(4)(b)(i) Luxembourg-United States DTC; article 26(5)(a)(ii)(B) Netherlands-United States DTC; article 23(3)(a), (7)(d) United Kingdom-United States DTC; *cf., e.g.*, DeCarlo, J., A.W. Granwell, and S. van Weeghel, "An Overview of the Limitation on Benefits Article of the New Netherlands-U.S. Income Tax Convention," 22 *Tax Mgm't Int'l J.* 271 (276) (1993); Bennett, M.C. et. al., "A Commentary to the United States-Netherlands Tax Convention," *Intertax* 1993, 165 (199).

[38]*See* article 26(2)(h) Netherlands-United States DTC; *cf.* Berman, D.M. and J.L. Hynes, "Limitation on Benefits Clauses in U.S. Income Tax Treaties," *29 Tax Mgm't Int'l J*. 692 (703) (2000).

[39]Article 30(1)(c)(iii) France-United States DTC; article 26(1)(c)(iii) Netherlands-United States DTC; *see, e.g.,* Schinabeck, M.J., "The Limitation on Benefits Article of the U.S.-France Tax Treaty," 22 *Tax Mgm't Int'l J.* 26 (30) (1996); Delattre, O., "France-United States: New Tax Treaty," *BIFD* 1995, 65 (69); De Lignie, M., "Limitation on Benefits: Recently Signed U.S. Treaties Compared to the 1992 U.S.-Netherlands Treaty," *BIFD* 1995, 71 (74); Bennett, M.C. et. al., "A Commentary to the United States-Netherlands Tax Convention," *Intertax* 1993, 165 (198).

[40]Article 23(2)(g)(ii), (7)(d) United Kingdom-United States DTC.

clause in the treaty between the U.S. and Belgium limits its scope to dividends, interest, and royalties.[41]

C. The Issues

The complexity of some LoB articles in treaties between the United States and EU member states arises partly from the attempts to avoid interference with the fundamental freedoms of the EC Treaty.[42] In light of the potential infringement of the EC Treaty by LoB clauses,[43] member states have tried, albeit unsuccessfully, to extend the term "qualified persons" to all residents of EU member states.[44] The best results that were obtainable by the contracting member states include the derivative benefits concept in some treaties, the restricted considerations of EU membership in some LoB provisions, and references to the EU in the guidelines for competent authority determination under the subjective clauses.[45]

Despite those attempts, the basic issue of a possible infringement of the fundamental freedoms of the EC Treaty[46] is obvious. Generally, under the ownership and base erosion test of every LoB provision in treaties between the United States and EU member states, a corporation will qualify for treaty benefits only if a certain percentage of its shares, usually 50 percent,[47] is owned by certain persons who are themselves entitled to benefits under the LoB provision, such as resident individuals, publicly traded companies, or U.S. citizens. Ownership by residents of other EU member states in excess of that percentage will disqualify the corporation for treaty benefits. Although the ownership requirement differs from treaty to treaty, a common feature is that the ownership may be indirect through other persons. In that regard, a few treaties require that 50 percent of the shares be ultimately owned by qualified persons;[48] the ultimate owners are determined by disregarding any intermediate owners of the company and thereby tracing ownership to a person that is a qualified resident without reference to its owners.[49] In contrast to that ultimate ownership technique, most treaties require that, to count for indirect ownership, all persons in the chain of ownership must be qualified residents, that is, residents of the treaty partners qualifying under the

[41]Article 12A(1) Belgium-United States DTC.

[42]DeCarlo, J., A.W. Granwell, and S. van Weeghel, "An Overview of the Limitation on Benefits Article of the New Netherlands-U.S. Income Tax Convention," 22 *Tax Mgm't Int'l J.* 271 (279 *et seq*.) (1993).

[43]The alleged breach of Germany's EC obligations because of the LoB provision in the Germany-United States DTC was the subject of a question in the European Parliament; *see* Written Question 2046/90 by Mr. Gijs de Vries to the Commission of the European Communities, 5. 9. 1990 (91/C 79/47), OJ C 79/28 (25. 3. 1991).

[44]*See, e.g*., Troup, E., "Of Limited Benefits: Article 26 of the New U.S./Netherlands Double Tax Treaty Considered," *BTR* 1993, 97 (97 *et seq*.); DeCarlo, J., A.W. Granwell, and S. van Weeghel, "An Overview of the Limitation on Benefits Article of the New Netherlands-U.S. Income Tax Convention," 22 *Tax Mgm't Int'l J.* 271 (280) (1993).

[45]*See* Van Unnik, D. and M. Boudesteijn, "The New U.S.-Dutch Treaty and the Treaty of Rome," *EC Tax Rev.* 1993, 106 (107); Hinnekens, L., "Compatibility of Bilateral Tax Treaties With European Community Law — Application of the Rules," *EC Tax Rev.* 1995, 202 (229); Berman, D.M. and J.L. Hynes, "Limitation on Benefits Clauses in U.S. Income Tax Treaties," 29 *Tax Mgm't Int'l J.* 692 (699) (2000); Clark, B., "Limitation on Benefits: Changing Forms in the U.S.- U.K. Tax Treaty," *ET* 2003, 97 (98).

[46]*See* for a brief discussion of the freedom of establishment and the freedom of capital movement *infra* III.A.

[47]This means either more than 50 percent of each class of shares (article 16(1)(d)(i) Austria-United States DTC; article 12A(1)(a)(i) Belgium-United States DTC; article 17(1)(f)(i) Czech Republic-United States DTC; article 16(1)(d)(i) Finland-United States DTC; article 28(1)(e)(aa) Germany-United States DTC; article 17(1)(f)(i) Slovak Republic-United States DTC; article 17(1)(g)(i) Spain-United States DTC; article 17(1)(d)(i) Sweden-United States DTC), at least 50 percent of each class of shares (article 22(2)(c)(i); Estonia-United States DTC; article 23(2)(c)(i) Ireland-United States DTC; article 2(2)(f) Italy-United States Protocol; article 23(2)(c)(i) Latvia-United States DTC; article 23(2)(c)(i) Lithuania-United States DTC; article 22(2)(d)(i) Slovenia-United States DTC), more than 75 percent of the number of each class of shares (article 26(1)(a); Cyprus-United States DTC), at least 50 percent of vote and value (article 22(2)(f)(i); Denmark-United States DTC; article 23(2)(f)(i) United Kingdom-United States DTC), more than 50 percent of vote and value; article 30(1)(d) France-United States DTC; article 26(1)(d)(i) Netherlands-United States DTC), or at least 50 percent of the principal class of shares; article 24(2)(c)(i) Luxembourg-United States DTC).

[48]Article 24(2)(c)(i) Luxembourg-United States DTC; article 17(1)(e)(i) Portugal-United States DTC; *cf., e.g.,* Cohen, H.J., L.A. Pollack, and R. Molitor, "Analysis of the New U.S.-Luxembourg Income Tax Treaty," 25 *Tax Mgm't Int'l J.* 403 (419 *et seq*.) (1996).

[49]This group consists of persons that are considered qualified residents without reference to their ownership (if any), that is, in the case of the Luxembourg-United States DTC, resident individuals (article 24(2)(a)), the contracting state itself, a political subdivision or a local authority thereof (article 24(2)(b)), a publicly traded company (article 24(2)(d)), or a nonprofit organization (article 24(2)(f)); on the other hand, the qualification of companies (article 24(2)(c)) and subsidiaries of publicly traded companies (article 24(2)(e)) is made with reference to their owners and the latter two do not count toward the 50 percent ultimate ownership requirement; *see* Treasury Department Technical Explanation of the Luxembourg-United States DTC (article 24(2)(c)); *cf.* PLR 200201025.

respective LoB clause.[50] However, the treaty between the U.S. and the Netherlands is unique in that respect because it explicitly allows EU residents within the chain of ownership.[51]

It can be said that, for example, in the simple case in which a Dutch corporation is wholly owned by a resident of another member state, the Dutch corporation will not be able to claim treaty benefits unless it meets the active business or the headquarters test or is granted discretionary relief by the U.S. competent authority.[52] Wholly EU-owned Dutch companies that do not meet those tests and therefore fail to qualify under the treaty between the United States and the Netherlands face higher U.S. withholding taxes on dividends, interest, and royalties than would Dutch-owned companies. The distinction is disadvantageous to nonresident shareholders and may constitute an infringement of the EC Treaty. Apart from the ownership clauses, many other issues are raised by LoB clauses: for example, the complete exclusion of residents of Malta from the benefits of the Netherlands-United States DTC[53] and the ownership requirements under the indirect stock exchange test[54] may infringe on the freedom of establishment under articles 43 and 48 EC. Furthermore, LoB clauses that do not include every EU stock exchange for purposes of the direct stock exchange test may independently infringe on the freedom to provide services under article 49 EC, and the nonconsideration of deductible payments to EU residents for purposes of the base erosion test may infringe on the freedom to provide services under article 49 EC or on the freedom of capital movement under article 56 EC, as the case may be. However, the following discussion focuses on ownership clauses and their relation to the freedom of establishment, which is guaranteed in articles 43 and 48 EC. Nevertheless, the arguments presented are equally applicable to other fundamental freedoms, especially the freedom of capital movement.[55]

II. The Open Skies Judgments Of the ECJ

A. Nationality Clauses and EC Law: Quota Hopping and Treaty Shopping

Although LoB clauses in tax treaties are based on residence and not nationality, the effect of those clauses is comparable to so-called nationality clauses in domestic law or bilateral treaties. Before taking a closer look at the landmark decisions in the open skies cases, it is appropriate to reflect on the general ECJ's case law on related issues. The ECJ has frequently dealt with nationality clauses — that is, ownership percentage tests based on a nationality percentage —

[50]*See* article 22(2)(f) Denmark-United States DTC; article 22(2)(c)(i) Estonia-United States DTC; article 2(2)f)(i) Italy-United States Protocol; article 23(2)(c)(i) Latvia-United States DTC; article 23(2)(c)(i) Lithuania-United States DTC; article 26(8)(k) Netherlands-United States DTC; article 22(2)(d)(i) Slovenia- United States DTC. The situation is, however, less clear in the France-United States DTC because the definition in article 30(6)(a), which requires that all companies in the chain of ownership be residents of a contracting state or of an EU member state, only applies for purposes of the publicly traded test under article 30(1)(c)(ii) and (iii); however, because of the reverse wording in article 30(1)(d), which requires that 50 percent or more of the vote and value of the company's shares "is not owned, directly or indirectly, by persons that are not qualified persons" — as opposed to "is owned, directly or indirectly by qualified persons" (*see, e.g.,* article 26(1)(d) Netherlands-United States DTC) — the inquiry is whether, at some point in the ownership chain, a nonqualified person owns the entity. If a nonqualified person, including a resident of another member state, appears in the chain of ownership, the shares owned by that person are not counted; *see also* Schinabeck, M.J., "The Limitation on Benefits Article of the U.S.-France Tax Treaty," *22 Tax Mgm't Int'l J.* 26 (31) (1996). In contrast, article 23(2)(c)(i) Ireland-United States DTC only requires that the last owners in the chain fulfill the ownership test, which seems to correspond to the ultimate ownership requirement in article 24(2)(c)(i) Luxembourg-United States DTC and article 17(1)(e)(i) Portugal-United States DTC. Regarding article 23(2)(f) United Kingdom-United States DTC, neither the language of the treaty nor the technical explanation implies that all persons in the chain of ownership must be qualified residents; the same is true for article 16(1)(d)(i) Austria-United States DTC, article 12A(1)(a)(i) Belgium-United States DTC, article 17(1)(f)(i) Czech Republic-United States DTC, article 16(1)(d)(i) Finland-United States DTC, article 28(1)(e)(aa) Germany-United States DTC, and article 17(1)(g)(i) Spain-United States DTC.

[51]*See, e.g.*, Bennett, M.C. et al., Commentary to the U.S.-Netherlands Income Tax Convention (1995) article 26-81.

[52]*See* Van Unnik, D. and M. Boudesteijn, "The New U.S.-Dutch Treaty and the Treaty of Rome," *EC Tax Rev.* 1993, 106 (111).

[53]Article 26(8)(h) Netherlands-United States DTC defines the phrase "member state of the European Communities" as the Netherlands itself and any other member state with which both contracting parties have in effect a comprehensive DTC. Currently the Netherlands have DTCs with all other member states, and the U.S., with all member states except Malta, with which the United States has terminated its DTC as of January 1, 1997 (Treasury Department News Release (RR-717, Nov. 20, 1995); *see* "United States Terminates 1980 Income Tax Treaty With Malta," *95 TNI 230-25*; *cf.* the 1995 U.S. Notice of Termination, *96 TNI 71-38*). According to article 26(8)(h) Netherlands-United States DTC, Malta would not qualify as a member state of the European communities for several tests in the LoB clause, which may constitute an infringement of article 43 EC. *See, e.g.,* Doyle, H., "Is Article 26 of the Netherlands-United States Tax Treaty Compatible With EC Law?" *ET* 1995, 14 (14 et seq.); *cf.* Essers, P. and R.H.M.J. Offermanns, "Tax Treaties in Conflict with the EC Treaty: The Incompatibility of Anti-Abuse Provisions and EC Law," *22 Int'l Tax J.* 68 (1996).

[54]*See, e.g.*, Offermanns, R., "Tax Treaties in Conflict with the EC Treaty: The Incompatibility of Anti-Abuse Provisions and EC Law," *EC Tax Rev.* 1995, 97 (97).

[55]*See, e.g.,* Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus.* 165 (193) (1997).

and held that such clauses are discriminatory under the EC Treaty. The decided cases have, for the most part, revolved around the registration of fishing vessels.[56] Many countries have incorporated nationality requirements for the registration of such vessels to put a stop to a practice known as "quota hopping," whereby fishing quotas of a member state are plundered by vessels flying the respective member state's flag but lacking any genuine link with that member state. Those nationality requirements often include a clause stating that a certain percentage of the vessel or the company that operates the vessel must be owned by nationals of such member state to qualify for registration. It may be noted that the quota-hopping issue has striking similarities with the treaty-shopping issue: The quota planning of nonnational fishers resembles the tax planning of taxpayers who introduce into their corporate structure an intermediary company located in a favorable country to achieve access to the tax treaty network of that country.

The ECJ has repeatedly held that a nationality requirement is contrary to the freedom of establishment under articles 43 and 48 EC, regardless of its actual discriminatory effect.[57] The Court held that when a vessel constitutes an instrument by which a Community national pursues an economic activity that involves a fixed establishment in another member state, registration of that vessel cannot be dissociated from the exercise of the freedom of establishment. The conditions laid down for the registration of that vessel must therefore neither discriminate on the grounds of nationality nor form an obstacle to the exercise of that freedom. A condition stipulating that when a vessel is owned or chartered by natural persons, they must be of a particular nationality and, in the case of a company, the shareholders must be of that nationality, is contrary to article 43 EC. In later cases, the Court applied the same reasoning to national legislation regarding the registration of aircraft, which subjected natural and legal persons from other member states to a special regime requiring them to be resident or established in the respective member state for at least one year to have an aircraft registered there.[58]

Although it seems clear that nationality clauses in an intra-EU context cannot be upheld, those cases could easily be distinguished from situations in which a member state gives, by treaty, to a third country the right to discriminate against nationals or residents of other member states. Because EC law cannot create obligations for nonmember countries, including the United States, the source of that discrimination would lie in the entering into of such treaty by the respective member state.[59] However, this argument about discrimination is implicated by the recent open skies judgments of the ECJ.[60] In those judgments the Court held, *inter alia*, that the nationality clauses in the bilateral air services agreements between the United States and several EU member states, the so-called open skies agreements, infringe on the freedom of establishment. As the Court pointed out, that infringement consisted in the granting by a member state to the United States the right to revoke or limit authorizations of airlines when substantial ownership and effective control are not in the hands of nationals of the respective member state. The ECJ held that by concluding and applying such agreements, the member states have breached their EC obligations, since the nationality clauses potentially prevent EU airlines of one member state from establishing themselves in another member state and offering direct air service from that member state to the United States.

B. Background of the Open Skies Judgments

The facts of the open skies judgments are straightforward. In 1998 the Commission brought actions before the ECJ under article 226 EC against eight member states regarding breaches of EC law arising from the conclusion of bilateral air transport agreements with the United States, that is, the open skies agreements.[61] Among other things, including the impairment of the European Community's external competence, the Commission argued that the member

[56]ECJ 25. 7. 1991, C-221/89, ECR 1991, I-3905, *Factortame II*; ECJ 4. 10. 1991, C-246/89, ECR 1991, I-4585, *Commission / United Kingdom*; ECJ 4. 10. 1991, C-93/89, ECR 1991, I-4569, *Commission / Ireland*; ECJ 17. 11. 1992, C-279/89, ECR 1992, I-5785, *Commission / United Kingdom*; ECJ 7. 3. 1996, C- 334/94, ECR 1996, I-1307, *Commission / France*; ECJ 12. 6. 1997, C-151/96, ECR 1997, I-3327, *Commission / Ireland*; ECJ 27. 11. 1997, C-62/96, ECR 1997, I-6725, *Commission / Hellenic Republic*; see also ECJ 29. 10. 1998, C-114/97, ECR 1998, I-6717, *Commission / Spain*.

[57]*See, e.g.*, ECJ 25. 7. 1991, C-221/89, ECR 1991, I-3905, *Factortame II*.

[58]*See* ECJ 8. 7. 1999, C-203/98, ECR 1999, I-4899, *Commission / Belgium*.

[59]*See, e.g.*, Farmer, P., "EC Law and Direct Taxation — Some Thoughts on Recent Issues," *EC Tax J.* 1995/96, 91 (104 *et seq*.).

[60]ECJ 5. 11. 2002, C-466/98, ECR 2002, I-9427, *Commission / United Kingdom*; ECJ 5. 11. 2002, C-467/98, ECR 2002, I-9519, *Commission / Denmark*; ECJ 5. 11. 2002, C-468/98, ECR 2002, I-9575, *Commission / Sweden*; ECJ 5. 11. 2002, C-471/98, ECR 2002, I-9681, *Commission / Belgium*; ECJ 5. 11. 2002, C-472/98, ECR 2002, I-9741, *Commission / Luxemburg*; ECJ 5. 11. 2002, C-475/98, ECR 2002, I-9797, *Commission / Austria*; ECJ 5. 11. 2002, C-476/98, ECR 2002, I-9855, *Commission / Germany*.

[61]For a discussion of the open skies policy, see Schless, A.L., "Open Skies: Loosening the Protectionist Grip on International Civil Aviation," 8 *Emory Int'l L. Rev.* 435 (435 *et seq*.) (1994).

states infringed on article 43 EC, which prohibits any restrictions on the freedom of establishment of nationals[62] of a member state in the territory of another member state, by inserting or maintaining in those agreements so-called nationality clauses that allow each party to refuse the rights provided for under the agreements to air carriers designated by the other party but not substantially owned or effectively controlled by nationals of that state. The Commission pointed out that according to those clauses, an airline owned or controlled by nationals of a noncontracting member state and established in a member state that had concluded an open skies agreement with the United States would not receive the same treatment accorded to companies owned by nationals of that state and would thereby suffer discrimination contrary to EC law.

The defendant governments relied on the argument that discrimination, if any, could only be practiced by the United States because the nationality clauses do not restrict in any way the right of contracting member states to designate airlines from other member states. Rather, the clauses enable the United States — in accordance with the Chicago Convention — to withhold, revoke, suspend, or limit permissions or authorizations in respect of such airlines. Furthermore, article 43 of the EC Treaty should neither be applicable *ratione loci*, since the relevant economic activities are pursued on transatlantic routes and thus outside the EU, nor *ratione materiae*, since the nationality clauses relate only to the freedom to provide services, which in the sphere of air transport is protected only within the limits of the provisions of secondary law adopted pursuant to article 84 EC. Some member states argued that because the nationality clauses were already included in earlier agreements before the amendments in 1995 and 1996, these clauses pertained to agreements concluded before the entry into force of the EC Treaty or secondary law in the field of air transport and were therefore covered by article 307(1) EC, which provides that the "rights and obligations arising from agreements concluded before the entry into force of this Treaty between one or more Member States on the one hand, and one or more third countries on the other, shall not be affected by the provisions of this Treaty."[63]

C. The Open Skies Judgments: Infringement Of Article 43 EC by Nationality Clauses

Because the judgments of the ECJ were in line with recent case law and largely followed the advocate general's opinion, the outcome of the cases regarding the infringement of article 43 EC was not surprising.[64] The Court first reminded the member states that the application of article 43 EC[65] in a given case depends not on the question of whether the Community has legislated in the particular area at issue, but on whether the situation under consideration is governed by EC law. Even if a matter falls within the power of the member states, the fact remains that the member states must exercise that power consistently with EC law.[66] Regarding the applicability of article 43 EC *ratione materiae*, the ECJ said that, unlike article 51 EC, which precludes the EC Treaty provisions on the freedom to provide services from applying to transport services, there is no article in the treaty that precludes the freedom of establishment from applying to transport. The applicability of article 43 EC *ratione loci* is not excluded either, since all companies established in a member state within the meaning of article 43 EC are covered by that provision, even if their business in that state consists of services directed to nonmember countries.

After considering the proper applicability of article 43 EC, the Court stated that freedom of establishment includes the right of nationals of one member state to take up and pursue activities as self-employed persons and to set up and manage undertakings (in particular companies or firms within the meaning of article 48 EC) in another member state under the same conditions laid down for the host state's own nationals. Those provisions thus guarantee nationals of member states of the EU who have exercised their freedom of establishment, and companies or firms that are assimilated to them, the same treatment in the host member state as that accorded to nationals of that member

[62]Starting with the *avoir fiscal* judgment in 1986, the Court has consistently held that the seat of a company — in the sense of its registered office, central administration, or principal place of business — serves the function of nationality; *see* ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission/France* (*avoir fiscal*) — para. 18. This view has been confirmed, *inter alia*, in ECJ 13. 7. 1993, C-330/91, ECR 1993, I-4017, *Commerzbank* — para. 13, ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 20, and ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 35.

[63]*See* for a discussion of article 307 *infra* III.C.

[64]*See, e.g.*, Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (191); Lavranos, N., "European Court of Justice," 5 November 2002, *L. Issues of Econ. Int.* 2003, 81 (91); *see also* Farmer, P., "EC Law and Direct Taxation — Some Thoughts on Recent Issues," *EC Tax J.* 1995/96, 91 (104 *et seq.*).

[65]*See, e.g.*, ECJ 5. 11. 2002, C-475/98, ECR 2002, I-0907, *Commission/Austria (Open Skies)* — para. 131.

[66]*See also infra* III.A.1.

state,[67] regarding both initial establishment and ongoing activity. This principle of national treatment also requires access to the advantages of a bilateral treaty on the same conditions as those which apply to nationals in the member state that is a party to the treaty.[68]

The Court concluded that for airlines established in a member state that is party to such an agreement, but which were substantially owned and effectively controlled by nationals of another member state, are capable of being affected by such clauses because the United States might withdraw, suspend, or limit the operating licenses or technical authorizations of that airline. In comparision, under the open skies agreements, the United States is under an obligation to grant the appropriate operating licenses and required technical authorizations to airlines of which a substantial part of the ownership and effective control is vested in nationals of an agreement partner. Therefore, the former airlines — the Community airlines — could be excluded from the benefit of the air transport agreement between a certain member state and the United States, while that benefit is assured to the latter airlines. Consequently, Community airlines suffer discrimination that prevents them from benefiting from the treatment that the host member state — that is, the agreement partner — accords its own nationals.

The Court also emphasized that the potential conduct of the United States was not the source of discrimination. Rather, the potential discrimination was due to the presence of the clause on the ownership and control of airlines, which specifically acknowledged the right of the United States to act in that manner and thereby discriminate against Community airlines.[69] Therefore, the nationality clauses are contrary to article 43 EC. It may be noted that in some of those cases, the ECJ also considered and rejected a possible justification of such discrimination on the grounds of public policy under article 46 EC.[70] However, the ECJ expressly dealt with the safeguard clause in article 307(1) EC in the context of the nationality clauses, stating that amendments to an agreement are proof of renegotiation of the preexisting agreement in its entirety. It follows that, even if some provisions of an agreement were not formally modified by later amendments or were subject only to marginal changes in drafting, the commitments arising from those provisions were nevertheless confirmed in the renegotiation.[71] In that case, the member states are prevented not only from contracting new international commitments but also from maintaining those commitments in force if they infringe EC law.[72]

D. Consequences

Clearly the landmark decisions in the open skies cases reveal much about the relationship between freedom of establishment under the EC Treaty and bilateral agreements of member states with third countries.[73] However, the Court did not completely lift

[67]*See, e.g.*, ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission/France* — para. 18; ECJ 13. 7. 1993, C-330/91, ECR 1993, I-4017, *Commerzbank* — para. 13; ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 20; ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 35.

[68]The ECJ had already held that a member state that is a party to a bilateral international treaty with a nonmember country for the avoidance of double taxation can grant to permanent establishments of companies resident in another member state the advantages provided for by that treaty on the same conditions as those that apply to companies resident in the member state that is party to the treaty; *see* ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 59; ECJ 15. 1. 2002, C-55/00, ECR 2002, I-413, *Gottardo* — para. 32.

[69]*See, e.g.*, ECJ 5. 11. 2002, C-475/98, ECR 2002, I-9797, *Commission/Austria (open skies)* — para. 142.

[70]The Court said that recourse to justification on grounds of public policy under article 46 of the treaty presupposes the need to maintain a discriminatory measure to deal with a sufficiently serious threat affecting one of the fundamental interests of society (*see*, ECJ 5. 11. 2002, C-466/98, ECR 2002, I-9427, *Commission/United Kingdom* — para. 57; *cf.,* ECJ 27. 10. 1977, 30/77, ECR 1977, 1999, *Bouchereau* — para. 35; ECJ 29. 10. 1998, C-114/97, ECR 1998, I-6717, *Commission v. Spain* — para. 46; ECJ 19. 1. 1999, C-348/96, ECR 1999, I-11, *Calfa* — para. 21). It follows that there must be a direct link between that threat, which must, moreover, be current, and the discriminatory measure adopted to deal with it (*see*, to that effect, ECJ 26. 4. 1988, ECR 1988, 2085, *Bond van Adverteerders* — para. 36; ECJ 19. 1. 1999, C-348/96, ECR 1999, I-11, *Calfa* — para. 24); in this case, such a link was not present because the nationality clauses did not limit the power to refuse operating authorizations or the necessary technical permissions to an airline designated by the other party solely to circumstances in which that airline represents a threat to the public policy of the party granting those authorizations and permissions (*see* ECJ 5. 11. 2002, C-466/98, ECR 2002, I-9427, *Commission/United Kingdom (open skies)* — para. 58).

[71]*See, e.g.*, ECJ 5. 11. 2002, C-475/98, ECR 2002, I-9797, *Commission/Austria (open skies)* — para. 47 *et seq*.; *see* also Panayi, C., "Open Skies for European Tax?" *BTR 2003*, 189 (193 *et seq*.); Sørensen, F., W. van Weert, and A. Cheng-Jui Lu, "ECJ Ruling on Open Skies Agreements v. Future International Air Transport," *Air & Space L.* 2003, 3 (11).

[72]ECJ 5. 11. 2002, C-475/98, ECR 2002, I-9797, *Commission/Austria (open skies)* — para. 49; *see also* ECJ 4. 7. 2000, C-62/98, ECR 2000, I-5171, *Commission/Portugal*; ECJ 4. 7. 2000, C-84/98, ECR 2000, I- 5215, *Commission/Portugal*.

[73]*See* for a discussion of the effects on international air transportation, Mendes de Leon, P., "Before and After the Tenth Anniversary of the Open Skies Agreement Netherlands-U.S. of 1992," *Air & Space L.* 2002, 280 (280 *et seq*.); Sørensen, F., W. van Weert, and A. Cheng-Jui Lu, "ECJ Ruling on Open Skies Agreements v. Future International Air Transport," *Air & Space L.* 2003, 3 (3 *et seq*.); Wassenbergh, H., "The Decision of the ECJ of 5 November 2002 on the 'Open Skies' Agreements Cases," *Air & Space L.*

(continued on next page)

the curtain regarding all of its reasoning, especially the correspondence with the earlier *Saint-Gobain* judgment.[74] In the *Saint-Gobain* case, the ECJ stated that the obligations imposed by EC law on a member state do not affect in any way those resulting from its agreements with third countries. The balance and the reciprocity of the treaties concluded by a member state with third countries would not be called into question by a unilateral extension of benefits on the part of the member state, since an extension would not in any way affect the rights of the nonmember countries that are parties to the treaties and would not impose any new obligation on them.[75] If that holding were transferred to the open skies cases, it could be argued that article 43 EC cannot require amendment of agreements already concluded with nonmember countries to impose new obligations on them, for example, regarding authorizations issued by the United States that concern the use of United States' airspace.[76] However, the Court did not find that argument persuasive. It distinguished *Saint-Gobain*[77] and said that, where the infringement of EC law results directly from a bilateral international agreement concluded by a member state after its accession to the EU, the Court is not prevented from finding that infringement exists on the ground that such a finding would not compromise the rights that nonmember countries derive from the very provision that infringes EC law.[78]

Therefore, to comply with the *Saint-Gobain* judgment, which requires the unilateral extension of tax advantages enjoyed by companies with a seat in a member state to permanent establishments of taxpayers of other member states — whether pursuant a double taxation treaty with a nonmember state or the domestic tax system of the member state[79] — is no longer a sufficiently exonerating factor.[80] However, it may go too far to conclude that compromising the rights of a nonmember state treaty partner is no longer a restraining factor.[81] To clarify, the open skies judgments do not have — and can not have — a *de jure* effect on the United States.[82] Because the Court shifts the blame to the member states that concluded the open skies agreements with the United States, no positive obligation, such as an obligation to amend a treaty or to otherwise confer similar rights to Community-owned airlines, is conferred on a nonmember state.[83] Rather, the Court places the liability — and therefore a possible claim in damages — on the respective member states, which are undisputedly within its jurisdiction.

That said, the Court did not indicate what should happen to the agreements in question, leaving their status unclear. The Commission has already requested the defendant member states to denounce their indi-

Footnote 73 continued

2003, 19 (19 *et seq*.); Wassenbergh, H., "A Mandate to the European Commission to Negotiate Air Agreements with Non-EU States: International Law versus EU Law," *Air & Space L.* 2003, 139 (139 *et seq*.); Slot, P.J. and J.D. de la Rochère, "Open skies judgments," *CML Rev.* 2003, 697 (697 *et seq*.); Abeyratne, R., "The Decision of the European Court of Justice on Open Skies and Competition Cases," *World Comp.* 2003, 335 (335 *et seq*.); Abeyratne, R., "The Decision of the European Court of Justice on Open Skies — How Can We Take Liberalization to the Next Level?" 68 *J. of Air L. and Com.* 485 (485 *et seq*.) (2003); Grant, T.D., "An End to 'Divide and Conquer'? EU May Move Toward More United Approach in Negotiating 'Open Skies' Agreements with USA," 67 *J. of Air L. and Com.* 1057 (1057 *et seq*.) (2003). For a discussion of the open skies policy, see Schless, A.L., "Open Skies: Loosening the Protectionist Grip on International Civil Aviation," 8 *Emory Int'l L. Rev.* 435 (435 *et seq*.) (1994).

[74]ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain*.

[75]ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 59, 60; *see also* the Opinion of Advocate General Mischo 2. 3. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 81 *et seq*.

[76]*See* for this ECJ 5. 11. 2002, C-466/98, ECR 2002, I-9427, *Commission / United Kingdom (open skies)* — para. 36.

[77]In paras. 59 and 60 of the *Saint-Gobain* judgment (ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain*) the ECJ "merely held that the extension to permanent establishments of companies having their seat in a Member State other than the Federal Republic of Germany of a tax advantage provided for by a bilateral international agreement concluded by the Federal Republic of Germany with a non-member country could be decided upon unilaterally by the former without in any way affecting the rights of the non-member country arising from that agreement and without imposing any new obligations on that non-member country"; *see* ECJ 5. 11. 2002, C-466/98, ECR 2002, I-9427, *Commission / United Kingdom (open skies)* — para. 54.

[78]ECJ 5. 11. 2002, C-466/98, ECR 2002, I-9427, *Commission / United Kingdom (open skies)* — para. 54.

[79]For a discussion of the *Saint-Gobain* case, *see, e.g.,* Offermanns, R. and C. Romano, "Treaty Benefits for Permanent Establishments: The *Saint-Gobain* Case," *ET* 2000, 180 (180 *et seq*.); Kostense, H.E., "The *Saint-Gobain* case and the application of tax treaties: Evolution or revolution?" *EC Tax Rev.* 2000, 220 (220 *et seq*.); Peters, C. and M. Snellaars, "Nondiscrimination and Tax Law: Structure and Comparison of the Various Non-Discrimination Clauses," *EC Tax Rev.* 2001, 13 (13 *et seq*.); Dourado, A.P., "From the *Saint-Gobain* to the *Metallgesellschaft* Case: Scope of Nondiscrimination of Permanent Establishments in the EC Treaty and the Most-Favoured-Nation Clause in EC Member States Tax Treaties," *EC Tax Rev.* 2002, 147 (147 *et seq*.).

[80]*See, e.g.*, Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (192).

[81]This is argued by Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (192).

[82]*See, e.g.*, Tumpel, M., "Europarechtliche Besteuerungsmaßstäbe für die grenzüberschreitende Organisation und Finanzierung von Unternehmen," in *Pelka, J.* (Ed.), *Europa- und verfassungsrechtliche Grenzen der Unternehmensbesteuerung DStJG* 23 (2000) 321 (353 *et seq*.); Terra, B. and P. Wattel, *European Tax Law* (2001) 113 *et seq*.

[83]*But see* Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (192).

vidual bilateral agreements with the United States.[84] Regarding nationality clauses, a possible course of action may be the renegotiation of the open skies agreements; if, however, the United States and the respective member states cannot agree on deletion of the nationality clause in the agreements, another course of action might be to replace the nationality clause with an EU ownership clause.[85]

III. Limitation on Benefits Clauses and EC Law

A. The Fundamental Freedoms of the EC Treaty and Direct Taxation: A Brief Overview

1. The ECJ and Direct Taxation

Since the EC Treaty does not contain provisions for direct taxes comparable to provisions pertaining to indirect taxes,[86] the member states retain their competence in direct tax matters such as the individual and corporate income tax.[87] But even if a matter falls within the power of the member states, they must exercise that power consistently with EC law and therefore especially avoid any overt or covert discrimination on grounds of nationality.[88] Generally, such discrimination arises through the application of different rules to comparable situations or the application of the same or a similar rule to different situations.[89]

The point at which EC law and national laws on direct taxation meet is a result of the combined application of the four freedoms of the EC Treaty and the principle of equal treatment. The principle of equal treatment, which the Court has derived in part from the EC Treaty[90] and from the national laws of member states, has had a decisive influence on the interpretation of the EC Treaty itself. It is of particular importance to, and forms a fundamental element of, the provisions of the Treaty that establish the Internal Market. It is often pointed out that violations of the equal treatment principles generate tax obstacles to cross-border economic activity in the Internal Market.[91] In EC law, the prohibition of discrimination is a common thread for the freedoms provisions: Article 39 EC guarantees freedom of movement for workers within the Community, including the abolition of any discrimination based on nationality; article 43 EC prohibits restrictions on the freedom of establishment of nationals of a member state in the territory of

[84]*See* the press release "European Commission Requests the Denunciation of the Bilateral Open Sky Agreements," 20. 11. 2002, IP/02/1713. Another alternative suggested in legal writing is that the member states could maintain the agreements if the United States was willing to delete the offending parts of the agreements so that only provisions that fell within member states' competence would remain; *see, e.g.*, Sørensen, F., W. van Weert, and A. Cheng-Jui Lu, "ECJ Ruling on Open Skies Agreements v. Future International Air Transport," *Air & Space L.* 2003, 3 (14 *et seq*.).

[85]The negotiations on the insertion of an EC ownership clause could be argued to fall within the community's exclusive competence; *see* Sørensen, F., W. van Weert, and A. Cheng-Jui Lu, "ECJ Ruling on Open Skies Agreements v. Future International Air Transport," *Air & Space L.* 2003, 3 (15).

[86]Article 90 *et seq*. EC; *see, e.g.*, Terra, B. and P. Wattel, *European Tax Law,* 3rd ed., (2001) 5 *et seq*., 235 *et seq*.

[87]Harmonization in the field of direct taxation is still limited to some directives, e.g., the Council Directive 90/435/EEC of July 23, 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states, OJ L 225, 6 (20. 8. 1990), which eliminates double taxation of dividends paid by a subsidiary in one member state to a parent company in another; *see, e.g.,* Terra, B. and P. Wattel, *European Tax Law,* 3rd ed., (2001) 335 *et seq*.

[88]*See, e.g.*, ECJ 25. 7. 1991, C-221/89, ECR 1991, I-3905, *Factortame II* — para. 14; ECJ 4. 10. 1991, C-246/89, ECR 1991, I-4585, *Commission / United Kingdom* — para. 12; ECJ 14. 2. 1995, C-279/93, ECR 1995, I-225, *Schumacker* — para. 21; ECJ 11. 8. 1995, C-80/94, ECR 1995, I-2493, *Wielockx* — para. 16; ECJ 27. 6. 1996, C-107/94, ECR 1996, I-3089, *Asscher* — para. 36; ECJ 15. 5. 1997, C-250/95, ECR 1997, I-2471, *Futura Participations*

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Footnote 88 continued

and Singer — para. 19; ECJ 28. 4. 1998, C-118/96, ECR 1998, I-1897, *Safir* — para. 21; ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 19; ECJ 29. 4. 1999, C-311/97, ECR 1999, I-2651, *Royal Bank of Scotland* — para. 19; ECJ 14. 9. 1999, C-391/97, ECR 1999, I-5451, *Gschwind* — para. 20; ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 57; ECJ 26. 10. 1999, C-294/97, ECR 1999, I-7447, *Eurowings* — para. 32; ECJ 28. 10. 1999, C-55/98, ECR 1999, I-7641, *Bent Vestergaard* — para. 15; ECJ 13. 4. 2000, C-251/98, ECR 2000, I-2787, *Baars* — para. 17; ECJ 6. 6. 2000, C-35/98, ECR 2000, I-4071, *Verkooijen* — para. 32; ECJ 19. 9. 2000, C-156/98, ECR 2000, I-6857, *Germany / Commission* — para. 80; ECJ 14. 12. 2000, C-141/99, ECR 2000, I-11619, *AMID* — para. 19; ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 37; ECJ 15. 1. 2002, C-55/00, ECR 2002, I-413, *Gottardo* — para. 32; ECJ 12. 9. 2002, C-431/01, ECR 2002, I-7073, *Mertens* — para. 25; ECJ 3. 10. 2002, C-136/00, ECR 2002, I-8147, *Danner* — para. 28; ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 32; ECJ 12. 12. 2002, C-324/00, ECR 2002 I-11779, *Lankhorst-Hohorst* — para. 26; ECJ 12. 12. 2002, C-385/00, ECR 2002, I-11819, *De Groot* — para. 75; ECJ 26. 6. 2003, C-422/01, ECR 2003, I-6817, *Ramstedt* — para. 25.

[89]ECJ 14. 2. 1995, C-279/93, ECR 1995, I-225, *Schumacker* — para. 30; ECJ 11. 8. 1995, C-80/94, ECR 1995, I- 2493, *Wielockx* — para. 17; ECJ 27. 6. 1996, C-107/94, ECR 1996, I-3089, *Asscher* — para. 40; ECJ 29. 4. 1999, C-311/97, ECR 1999, I-2651, *Royal Bank of Scotland* — para. 26; ECJ 14. 9. 1999, C-391/97, ECR 1999, I-5451, *Gschwind* — para. 21; ECJ 12. 9. 2002, C-431/01, ECR 2002, I-7073, *Mertens* — para. 32. However, very different treatment of not very different situations may be seen as a third category; *see* Lyal, R., "Non-Discrimination and Direct Tax in Community Law," *EC Tax Rev. 2003*, 68 (68).

[90]*See, e.g.*, articles 12, 34, 39, 43, 49, 56, and 58 EC Treaty.

[91]*See, e.g.*, "Company Taxation in the Internal Market," SEC(2001)1681, 309 *et seq*.

another member state; article 49 EC prohibits restrictions on freedom to provide services within the Community; and article 56 EC prohibits restrictions on the movement of capital between member states and between member states and third countries, subject to certain caveats contained in article 58 EC. Those freedoms aim to remove the borders between the member states for intra-EC economic activities, and give specific expression to the general prohibition of discrimination on grounds of nationality contained in article 12 EC, which is itself a manifestation of the principle of equal treatment. Because of the so-called convergence of the fundamental freedoms, all four freedoms basically follow the same pattern of protection of cross-border economic activities in their respective form.[92] It must be noted that each of the treaty freedoms is directly applicable in the member states and takes precedence over domestic legislation to the extent of any conflict.[93] Undoubtedly, the fundamental freedoms of the EC Treaty apply also to provisions in double taxation treaties;[94] EC law, of course, also prevails over bilateral treaties by virtue of hierarchy — *lex superior derogat de lege inferiori*.[95]

The overriding importance of those provisions regarding direct taxation became clear in 1986, when the Court extended its case law on the fundamental freedoms to the sphere of direct taxation in its judgment in the *Commission v. France* case,[96] commonly known as *avoir fiscal*. The Court held that a national tax law that refused a dividend imputation tax credit to permanent establishments of foreign (nonresident) companies, while granting it to resident companies, was contrary to Community law. Not surprisingly, the decision caused a great deal of confusion among practitioners of international tax law at the time; for them, it was practically unheard of that nonresidents and residents could not be subjected to different tax treatment. Such different treatment is usually a cornerstone of national tax laws. However, since the decision in *avoir fiscal*, the jurisprudence in that area has developed rapidly and it is fair to say that of all the Community institutions, the Court has so far proved to be the most efficient at removing tax obstacles to cross-border economic activities within the Community. Still, it should be noted that the ECJ promotes "negative integration" and it is broadly agreed that this cannot be a substitute for "positive integration," which has to be achieved by policy action by the Commission.

2. Overt and Covert Discrimination on Grounds of Nationality in Tax Law

The nondiscrimination principle of the EC Treaty, as specifically laid down in the fundamental freedoms, applies by reference to nationality. That is, as article 12 EC states, "discrimination on grounds of nationality

[92]*See* extensively Cordewener, A., *Europäische Grundfreiheiten und nationales Steuerrecht* (2002) 103 *et seq*.

[93]ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission / France* (*avoir fiscal*) — para. 13; ECJ 27. 9. 1988, 81/87, ECR 1988, 5483, *Daily Mail* — para. 15; ECJ 12. 4. 1994, C-1/93, ECR 1994, I-1137, *Halliburton Services* — para. 16; ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 33; ECJ 29. 4. 1999, C-311/97, ECR 1999, I-2651, *Royal Bank of Scotland* — para. 22; ECJ 13. 4. 2000, C-251/98, ECR 2000, I-2787, *Baars* — para. 27. While the provisions on the free movement of goods, services, and persons were considered to be directly applicable in the member states since the end of the transitional period on 31. 12. 1969 (*see, e.g.,* ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 41), the free movement of capital has a somewhat turbulent history: In a nutshell, article 67 of the EC Treaty was considered not to be directly applicable (ECJ 11. 11. 1981, 203/80, ECR 1981, 2595, *Casati* — para. 10 *et seq*.; ECJ 14. 11. 1995, C-484/93, ECR 1995, I3955, *Svensson and Gustavsson* — para. 5 *et seq*.). However, the restrictions on movements of capital were abolished by Council Directive 88/361/EEC of June 24, 1988 for the implementation of article 67 of the Treaty (OJ 1988 L 178, 5), which took effect July 1, 1990 (see ECJ 23. 2. 1995, C-358/93 and 416/93, ECR 1995, I-361, *Bordessa* — para. 32 *et seq*.; ECJ 14. 11. 1995, C-484/93, ECR 1995, I3955, *Svensson and Gustavsson* — para. 6). Effective January 1, 1994, the Maastricht Treaty introduced new provisions on capital and payments in the EC Treaty, including article 73b, which substantially reproduced the contents of article 1 of Directive 88/361/EEC. After the Treaty of Amsterdam, article 73b was renumbered as article 56 EC. Since July 1, 1990, the freedom of capital movement is directly applicable in the member states (see ECJ 23. 2. 1995, C-358/93 and 416/93, ECR 1995, I-361, *Bordessa* — para. 32 *et seq*.). However, the concept of the movement of capital is not defined in article 56 or in the directive. Nevertheless, the nomenclature of capital movements in Annex I of the Directive indicates the scope of capital movements for the purpose of article 56 EC (*see, e.g.,* ECJ 16. 3. 1999, C-222/97, ECR 1999, I-1661, *Trummer und Mayer* — para. 21; ECJ 11. 1. 2001, C-464/98, ECR 2001, I-0173, *Stefan* — para. 5; *see also* EFTA-Court 14. 7. 2000, E-1/00, *Íslandsbanki* — para. 14 ff).

[94]*See, e.g.,* Lang, M., "Die Bindung der Doppelbesteuerungsabkommen an die Grundfreiheiten des EU-Rechts," in Gassner, W., M. Lang, and E. Lechner (Eds.), *Doppelbesteuerungsabkommen und EU-Recht* (1996) 25 (27 *et seq*.); Pistone, P., *The Impact of Community Law on Tax Treaties* (2002) 11 *et seq*.; Randelzhofer, A. and U. Forsthoff, "Freiheiten und direkte Steuern," in Grabitz, E. and M. Hilf. (Eds.), *Das Recht der Europäischen Union* (2003), Vor article 39-55 para. 256 *et seq*. *Cf.* ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission / France* (*avoir fiscal*) — para. 26; ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 58.

[95]*See, e.g.*, Pistone, P., *The Impact of Community Law on Tax Treaties* (2002) 84; *cf.* Hinnekens, L., "Compatibility of Bilateral Tax Treaties With European Community Law — The Rules," *EC Tax Rev*. 1994, 146 (160); *see also* ECJ 27. 2. 1962, 10/61, ECR 1961, 1, *Commission / Italy*.

[96]ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission / France* (*avoir fiscal*).

shall be prohibited."[97] Regarding companies or firms formed in accordance with the laws of a member state, their corporate seat[98] serves to determine, like nationality for natural persons, their connection to a member state's legal order,[99] without regard to the residence of their shareholders. For example, the freedom of establishment under articles 43 and 48 EC guarantees to nationals of the member states and companies that are assimilated to them the same treatment in a host member state as that accorded to nationals of that member state.[100] That includes, under article 43 EC, "the setting-up of agencies, branches, or subsidiaries by nationals of any member state established in the territory of any member state." A difference in tax treatment based on the place of incorporation of a corporate entity may therefore amount to a so-called overt discrimination. The interpretation is based on the wording of article 43 EC, under which "restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited."

Furthermore, the ECJ has made clear that the rules regarding equal treatment forbid not only *overt* discrimination by reason of nationality but also *covert* forms of discrimination, which, by the application of other criteria of differentiation, lead to the same result.[101] That is especially important for tax rules, since, in principle, none of the member states imposes its taxing rights by reference to the nationality of the taxpayers but operates with the concept of residence.[102] Therefore, differences in treatment based on tax residence are treated as giving rise to covert, or

[97]Note that the ECJ has expanded the scope of the fundamental freedoms well beyond the prohibition of discrimination. The provisions regarding the treaty freedoms refer to restrictions to the exercise of the freedoms guaranteed by them. In its nontax case law, the Court has repeatedly held that nondiscriminatory restrictions to the free movement of goods are unlawful unless justified by defined imperative requirements of public interest. As early as in 1974, in its decision in the *Dassonville* case (ECJ 11. 7. 1974, 8/74, ECR 1974, 837, *Dassonville*), the Court held that all trading rules that are capable of hindering directly or indirectly, actually or potentially, intra-EC trade contradict article 28 EC. In the widely cited decision in the *Cassis-de-Dijon* case (ECJ 20. 2. 1979, 120/78, ECR 1979, 649, *Rewe-Zentral AG*), the Court qualified the compatibility of those restrictions with the treaty freedoms (because of their negative effect on trade) to situations in which they are necessary for the protection of certain public interests, such as fiscal supervision, public health, and consumer protection. Therefore, for example, domestic product regulations cannot be applied to products imported from other member states although they did not discriminate against imported goods, unless the restrictions can be justified on imperative grounds, such as fair trading, consumer protection, and environmental protection. In the *Säger* case (ECJ 25. 7. 1991, C-76/90, ECR 1991, I-4221, *Säger*), the Court extended the restriction-based approach to cover the free provision of services. In the direct tax sphere, the Court has so far only applied that analysis unequivocally to compliance issues, such as accounting records required of a branch to substantiate losses (*see* ECJ 15. 5. 1997, C-250/95, ECR 1997, I-2471, *Futura Participations and Singer*; *cf.* Lyal, R., "Nondiscrimination and direct tax in Community law," *EC Tax Rev. 2003*, 68 (70 *et seq.*); Farmer, P., "The Court's case law on taxation: a castle built on shifting sands?" *EC Tax Rev. 2003,* 75 (78 *et seq.*)). However, there are hints of a broader approach and the tendency in the Court's analysis can be interpreted as being toward a restriction-based approach. However, the issue of LoB provisions is clearly an issue of nondiscrimination, that is, the equality component of the four freedoms, and not a question of nonrestriction, that is, the liberty component of the four freedoms. *See* for the scope of the latter in tax law, *e.g.,* Terra, B. and P. Wattel, *European Tax Law,* 3rd ed., (2001) 41 *et seq.*; Cordewener, A., *Europäische Grundfreiheiten und nationales Steuerrecht* (2002) 843 *et seq.*; *cf.* Randelzhofer, A. and U. Forsthoff, "Freiheiten und direkte Steuern," in Grabitz, E. and M. Hilf (Eds.), *Das Recht der Europäischen Union* (2003), Vor article 39-55 para. 216.

[98]Article 48 EC requires that companies formed in accordance with the law of a member state and having their registered office, central administration, or principal place of business within the EU are to be treated in the same way as natural persons who are nationals of member states; *see, e.g.,* ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission/France* (*avoir fiscal*) — para. 18; ECJ 13. 7. 1993, C-330/91, ECR 1993, I-4017, *Commerzbank* — para. 13; ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 20; ECJ 29. 4. 1999, C-311/97, ECR 1999, I-2651, *Royal Bank of Scotland* — para. 23; ECJ 14. 12. 2000, C-141/99, ECR 2000, I-11619, *AMID* — para. 20.

[99]ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission/France* (*avoir fiscal*) — para. 18; ECJ 13. 7. 1993, C-330/91, ECR 1993, I-4017, *Commerzbank* — para. 13; ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 20; ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 35; ECJ 29. 4. 1999,

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Footnote 99 continued

C-311/97, ECR 1999, I-2651, *Royal Bank of Scotland* — para. 23; ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 42; ECJ 14. 12. 2000, C-141/99, ECR 2000, I-11619, *AMID* — para. 20.

[100]ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission/France* (*avoir fiscal*) — para. 13 *et seq.*; ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 34; Case C-264/96 *ICI*, Para. 20; ECJ 29. 4. 1999, C-311/97, ECR 1999, I-2651, *Royal Bank of Scotland* — paras. 22 and 23; ECJ 13. 7. 1993, C-330/91, ECR 1993, I-4017, *Commerzbank* — para. 13; ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 41 *et seq.*; ECJ 14. 12. 2000, C-141/99, ECR 2000, I-11619, *AMID* — para. 20.

[101]ECJ 13. 7. 1993, C-330/91, ECR 1993, I-4017, *Commerzbank* — para. 14; ECJ 12. 4. 1994, C-1/93, ECR 1994, I-1137, *Halliburton Services* — para. 15; ECJ 14. 2. 1995, C- 279/93, ECR 1995, I-225, *Schumacker* — para. 26; ECJ 8. 7. 1999, C-254/97, ECR 1999, I-4809, *Baxter* — para. 10; ECJ 16. 5. 2000, C-87/99, ECR 2000, I-3337, *Zurstrassen* — para. 18; ECJ 19. 9. 2000, C-156/98, ECR 2000, I-6857, *Germany/Commission* — para. 83; *cf.* ECJ 26. 10. 1999, C-294/97, ECR 1999, I-7447, *Eurowings* — para. 33.

[102]*See*, *ex multis*, Knobbe-Keuk, B., "Restrictions on the Fundamental Freedoms Enshrined in the EC Treaty by Discriminatory Tax Provisions — Ban and Justification," *EC Tax Rev.* 1994, 74 (76); Gammie, M. and G. Brannan, "EC Law Strikes at the UK Corporation Tax — The Death Knell of UK Imputation?" *Intertax 1995*, 389 (396); Jann, M., "Die Auswirkungen des EU-Rechts auf die Abkommensberechtigung von beschränkt Steuerpflichtigen," in Gassner, W., M. Lang, and E. Lechner (Eds.), *Doppelbesteuerungsabkommen und EU-Recht* (1996) 43 (57).

indirect, discrimination on the grounds that EU nonresidents usually are nationals of another member state.[103] However, it must be kept in mind that discrimination can only result from different treatment of similar situations, and vice versa; the comparability of situations therefore is a main cornerstone in the ECJ's case law.[104] In that regard, it should be noted that in a line of decisions — which seems, however, to be limited to benefits resulting from taking into account personal and family circumstances[105] — the situations of resident individuals and nonresident individuals are not generally comparable, unless it is established that, having regard to the purpose and content of the national provisions in question, the two categories of taxpayers are in a comparable situation.[106]

The archetypal form of discrimination that the Court has found unlawful arises in situations in which the tax treatment of residents of a member state is less burdensome than that to which nonresidents of that member state are subjected. For example, the Court has on several occasions found that less favorable tax treatment by a member state of a permanent establishment of a company established in another member state is discriminatory and incompatible with the treaty freedoms.[107] Although much of the case law regards nonresidents who are nationals of another member state, the EC Treaty also protects individuals from measures adopted by their own member state that restrict the exercise of treaty freedoms.[108] Furthermore, it is settled case law that discriminatory tax treatment of a subsidiary because its parent company is resident in another member state is prohibited.[109] In that respect, the ECJ has frequently dealt with cases in which tax benefits were denied to resident parent or subsidiary companies because their respective counterpart was resident in another member state. In every case, the ECJ has held that such treatment violated the EC Treaty. Thus, a host-state subsidiary cannot be treated less favorably because its parent company is a resident of another member state than a subsidiary of a host-state parent company.[110]

3. Justification and the Rule of Reason in Direct Taxation

Once it appears that a different rule applies to objectively comparable situations, either by explicit reference to nationality (that is, an overt discrimination), or to some other criterion that amounts to a distinction based on nationality (that is, a covert discrimination), the emphasis shifts to a consideration of whether the member state in question can justify that infringement of the freedoms guaranteed by the EC Treaty. While overt discrimination can be justified — under the current still-evolving case law of the ECJ — only under the very narrow circumstances explicitly described in the EC Treaty (that is, public policy, public security, or public health[111]), covert discrimination, as well as nondiscriminatory restrictions, may be justified based on a broader rule of reason.[112]

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[103]*See, e.g.,* ECJ 14. 2. 1995, C-279/93, ECR 1995, I-225, *Schumacker* — para. 28; ECJ 27. 6. 1996, C-107/94, ECR 1996, I-3089, *Asscher* — para. 38; ECJ 26. 10. 1999, C-294/97, ECR 1999, I-7447, *Eurowings* — para. 35; ECJ 12. 12. 2002, C- 324/00, ECR 2002 I-11779, *Lankhorst-Hohorst* — para. 28. *Cf, e.g.,* Oliver, D. B., "Tax Treaties and the Market-State", 56 *Tax L. Rev*. 587 (593 *et seq*.) (2003).

[104]*See, e.g.,* ECJ 29. 4. 1999, C-311/97, ECR 1999, I-2651, *Royal Bank of Scotland* — para. 27 *et seq*.

[105]*Cf., e.g.*, Randelzhofer, A. and U. Forsthoff, "Freiheiten und direkte Steuern," in Grabitz, E. and M. Hilf (Eds.), *Das Recht der Europäischen Union* (2003), Vor article 39-55 para. 228.

[106]*See, e.g.,* ECJ 14. 2. 1995, C-279/93, ECR 1995, I-225, *Schumacker* — para. 31 *et seq*.; ECJ 11. 8. 1995, C- 80/94, ECR 1995, I-2493, *Wielockx* — para. 18 *et seq*.; ECJ 27. 6. 1996, C-107/94, ECR 1996, I-3089, *Asscher* — para. 41; ECJ 14. 9. 1999, C-391/97, ECR 1999, I-5451, *Gschwind* — para. 22 *et seq*; ECJ 16. 5. 2000, C-87/99, ECR 2000, I-3337, *Zurstrassen* — para. 21 *et seq*. See also ECJ 29. 4. 1999, C- 311/97, ECR 1999, I-2651, *Royal Bank of Scotland* — para. 27 *et seq*.

[107]*See, e.g.,* ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission/France* (*avoir fiscal*); ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain*; ECJ 29. 4. 1999, C-311/97, ECR 1999, I-2651, *Royal Bank of Scotland*.

[108]*See, e.g.*, ECJ 27. 9. 1988, 81/87, ECR 1988, 5483, *Daily Mail* — para. 16; ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 21; ECJ 18. 11. 1999, C-200/98, ECR 1999, I-8261, *X AB and Y AB* — para. 26; ECJ 13. 4. 2000, C- 251/98, ECR 2000, I-2787, *Baars* — para. 28; ECJ 14. 12. 2000, C-141/99, ECR 2000, I-11619, *AMID* — para. 21; ECJ 12. 9. 2002, C-431/01, ECR 2002, I-7073, *Mertens* — para. 27; *cf., e.g.,* Lyal, R., "Non-discrimination and direct tax in Community law," *EC Tax Rev.* 2003, 68 (71); Farmer, P., "The Court's Case Law on Taxation: A Castle Built on Shifting Sands?" *EC Tax Rev.* 2003, 75 (77).

[109]*See* for a discussion of these situations, *e.g.,* Kofler, G., "Bosal: Abzugsverbot für Beteiligungsaufwendungen verstößt gegen die im Lichte der Niederlassungsfreiheit ausgelegte Mutter-Tochter-RL," *ÖStZ* 2003/1175, 554 (554 *et seq*.).

[110]ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 42; ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 38; ECJ 12. 12. 2002, C-324/00, ECR 2002 I-11779, *Lankhorst-Hohorst* — para. 32.

[111]*See* articles 39(3), 46(1), and 55 EC.

[112]*See* for a recent discussion of the relationship between the type of discrimination and the available grounds of justification, *e.g.,* Kofler, G., "Ramstedt: Benachteiligung von Beitragszahlungen an ausländische Rentenversicherer ist nicht mit der Dienstleistungsfreiheit vereinbar!" *ÖStZ* 2003/874, 404 (406 *et seq*.).

Focusing on the usual case of a covert discrimination in the tax area, under the rule of reason discrimination can be justified only if the discriminatory provision pursues a legitimate aim compatible with the EC Treaty and is justified by pressing reasons of public interest.[113] But even in that case, the discriminatory provision would have to be narrowly tailored to achieve the aim in question and not go beyond what was necessary for that purpose.[114] Therefore, to satisfy the proportionality test, the provision in question must be necessary in the sense that there would be no other, less restrictive means to protect the public interest in question. Regarding a justification for infringement, the ECJ's case law is, however, very restrictive. For example, the reduction in tax revenue cannot be regarded as a matter of overriding general interest that can be relied on to justify unequal treatment that is, in principle, incompatible with article 43 EC.[115] Neither can the host state justify a different tax treatment on the basis that the nonresident taxpayer or its subsidiary receives more favorable treatment under other rules of the host state's tax system.[116]

However, it is clear from the ECJ case law that the need to safeguard the cohesion of a tax system,[117] the prevention of tax evasion or tax avoidance,[118] or the effectiveness of fiscal supervision[119] can constitute overriding requirements of general interest capable of justifying a restriction on the exercise of fundamental freedoms guaranteed by the EC Treaty.[120] However, for example, the *in abstracto* recognition of the prevention of tax evasion as grounds of justification has, to date, *in concreto* never been able to save restrictive national measures brought before the ECJ.[121] Furthermore the Court has been very reluctant to accept justifications put forward on the basis of the administrative difficulties involved in ensuring efficient fiscal supervision or the prevention of tax avoidance.[122] The Court has taken the view that member states should, if necessary, provide each other with mutual assistance to overcome such difficulties.[123] Furthermore, as mentioned above,

[113]*See, e.g.,* ECJ 28. 1. 1992, C-204/90, ECR 1992, I-249, *Bachmann* — para. 21 *et seq*. ECJ 28. 1. 1992, C-300/90, ECR 1992, I-305, *Commission/Belgium* — para. 14 et seq.; ECJ 27. 6. 1996, C-107/94, ECR 1996, I-3089, *Asscher* — para. 49 *et seq*.; ECJ 3. 10. 2002, C-136/00, ECR 2002, I-8147, *Danner* — para. 33 *et seq*. and para. 44 *et seq*.

[114]ECJ 15. 5. 1997, C-250/95, ECR 1997, I-2471, *Futura Participations* — para. 26; ECJ 6. 6. 2000, C-35/98, ECR 2000, I-4071, *Verkooijen* — para. 43; ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 49; ECJ 12. 12. 2002, C-324/00, ECR 2002 I-11779, *Lankhorst-Hohorst* — para. 33.

[115]ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 28; ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 59; ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 51; ECJ 6. 6. 2000, C-35/98, ECR 2000, I-4071, *Verkooijen* — para. 48; ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 50.

[116]*See, e.g.,* ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission/France* (*avoir fiscal*) — para. 21; ECJ 13. 7. 1993, C-330/91, ECR 1993, I-4017, *Commerzbank* — para. 16 *et seq*.; ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 51 *et seq*.; ECJ 14. 12. 2000, C-141/99, ECR 2000, I-11619, *AMID* — para. 27.

[117]ECJ 28. 1. 1992, C-204/90, ECR 1992, I-276, *Bachmann* — para. 21 ff; ECJ 28. 1. 1992, C-300/90, ECR 1992, I-314, *Commission/Belgium* — para. 14 ff; however, since those two cases, which were basically decided upon a wrong factual and legal determination of the facts, the ECJ has subsequently denied a justification on the grounds of the cohesion of the tax system; *see, e.g.,* ECJ 14. 2. 1995, C-279/93, ECR 1995, I-225, *Schumacker* — para. 40 *et seq*.; ECJ 11. 8. 1995, C-80/94, ECR 1995, I-2493, *Wielockx* — para. 13 *et seq*.; ECJ 14. 11. 1995, C-484/93, ECR 1995, I-3955, *Svensson and Gustavsson* — para. 15 ff; ECJ 28. 10. 1999, C-55/98, ECR 1999, I-7641, *Bent Vestergaard* — para. 24; ECJ 16. 7.

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Footnote 117 continued

1998, C-264/96, ECR 1998, I- 4695, *ICI* — para. 29; ECJ 26. 10. 1999, C-294/97, ECR 1999, I-7447, *Eurowings* — para. 41 *et seq*.; ECJ 13. 4. 2000, C-251/98, ECR 2000, I-2787, *Baars* — para. 37 *et seq*.; ECJ 6. 6. 2000, C-35/98, ECR 2000, I-4071, *Verkooijen* — para. 49 *et seq*.; ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 67 *et seq*.; ECJ 3. 10. 2002, C-136/00, ECR 2002, I-8147, *Danner* — para. 33 *et seq*.; ECJ 12. 12. 2002, C-324/00, ECR 2002 I-11779, *Lankhorst-Hohorst* — para. 40 *et seq*.; ECJ 26. 6. 2003, C-422/01, ECR 2003, I-6817, *Ramstedt* — para. 30 *et seq*. *Cf., e.g.,* Thömmes, O., "Tatbestandsmäßigkeit und Rechtfertigung steuerlicher Diskriminierungen nach EG-Recht," in Schön, W. (Ed.), *GedS Knobbe-Keuk* (1997) 826 *et seq*.

[118]ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 26; ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 57; ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 61; ECJ 12. 12. 2002, C-324/00, ECR 2002, I-11779, *Lankhorst-Hohorst* — para. 37.

[119]ECJ 15. 5. 1997, C-250/95, ECR 1997, I-2471, *Futura Participations* — para. 31; ECJ 8. 7. 1999, C-254/97, ECR 1999, I-4809, *Baxter* — para. 18; ECJ 28. 10. 1999, C-55/98, ECR 1999, I-7641, *Bent Vestergaard* — para. 25; ECJ 3. 10. 2002, C-136/00, ECR 2002, I-8147, *Danner* — para. 51 *et seq*.

[120]*See*, in particular, as regards those justifications in the context of restrictions concerning a difference in income tax treatment, ECJ 28. 10. 1999, C-55/98, ECR 1999, I-7641, *Bent Vestergaard* — para. 23.

[121]*See* Terra, B. and P. Wattel, *European Tax Law,* 3rd ed., (2001) 77; *cf., e.g.,* ECJ 16. 7. 1998, C- 264/96, ECR 1998, I-4695, *ICI* — para. 26; ECJ 12. 12. 2002, C-324/00, ECR 2002 I-11779, *Lankhorst-Hohorst* — para. 37.

[122]*See, e.g.,* ECJ 8. 7. 1999, C-254/97, ECR 1999, I-4809, *Baxter* — para. 18 *et seq*.; ECJ 28. 10. 1999, C-55/98, ECR 1999, I-7641, *Bent Vestergaard* — para. 25 et seq.

[123]*See* the Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the member states in the field of direct taxation, OJ 1977 L 336, 15; *see* for the respective line of case law, *e.g.,* ECJ 14. 2. 1995, C-279/93, ECR 1995, I-225, *Schumacker* — para. 45; ECJ 28. 10. 1999, C-55/98, ECR 1999, I-7641, *Bent Vestergaard* — para. 26; ECJ 3. 10. 2002, C-136/00, ECR 2002, I-8147, *Danner* — para. 44 *et seq*; *cf.* Randelzhofer, A. and U. Forsthoff, "Freiheiten und direkte Steuern," in Grabitz, E. and M. Hilf (Eds.), *Das Recht der Europäischen Union* (2003), Vor article 39-55 para. 240.

a study of the case law concerning national rules on direct taxation shows that the Court has enforced the principle of nondiscrimination very strictly. In line with general principles developed outside the tax field, the Court has rejected several justifications for discriminatory measures advanced by member states, many of them repeatedly. Those proffered justifications include: the lack of harmonization of direct taxation;[124] that a nonresident could have avoided the discrimination, for example, by setting up a subsidiary company rather than a branch;[125] national economic aims or the protection of tax revenue;[126] the absence of reciprocity;[127] the existence of discretionary or equitable procedures to ensure appropriate fiscal treatment;[128] or the lower taxation of, for example, a service provider in its country of residence as a justification for higher, compensatory taxation of the recipient of the services.[129]

Finally, a particularly delicate area is the interpretation of the free movement of capital and payments as provided for in articles 56 and 58 EC; the latter makes an express reference to permissible restrictions and prohibits arbitrary discrimination and disguised restrictions. Under article 58(1)(a) EC, the member states retain the right "to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested"; article 58(3) EC, on the other hand, states specifically that the national provisions referred to by article 58(1)(a) EC are not to constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments, as defined in article 56 EC.[130] The interpretation of those clauses was unclear[131] and most legal writing suggested that they have only clarifying character.[132] In the *Verkooijen* case,[133] the ECJ confirmed that view and qualified article 58(1)(a) EC as a codification of its prior case law. The Court stated that according to that case law, the national tax provisions of the kind to which article 58(1)(a) EC refers, in so far as they establish certain distinctions based, in particular, on the residence of taxpayers, could be compatible with EC law, provided that they applied to situations that were not objectively comparable or could be justified by overriding reasons in the general

[124]*See, e.g.,* ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission / France* (*avoir fiscal*) — para. 24; ECJ 28. 1. 1992, C-204/90, ECR 1992, I-276, *Bachmann* — para. 10 *et seq*.; *cf.* Knobbe-Keuk, B., Restrictions on the Fundamental Freedoms Enshrined in the EC Treaty by Discriminatory Tax Provisions — Ban and Justification, EC Tax Rev. 1994, 74 (78 *et seq*.); Thömmes, O., "Tatbestandsmäßigkeit und Rechtfertigung steuerlicher Diskriminierungen nach EG-Recht," in Schön, W. (Ed.), *GedS Knobbe-Keuk* (1997) 821.

[125]ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission / France* (*avoir fiscal*) — para. 22; *see also* ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 42.

[126]ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 28; ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 59, ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 50; ECJ 6. 6. 2000, C-35/98, ECR 2000, I-4071, *Verkooijen* — para. 48; ECJ 3. 10. 2002, C-136/00, ECR 2002, I-8147, *Danner* — para. 56; ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 50; ECJ 12. 12. 2002, C-324/00, ECR 2002 I-11779, *Lankhorst-Hohorst* — para. 36.

[127]*See, e.g.,* ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission / France* (*avoir fiscal*) — para. 26; *cf.* Thömmes, O., "Tatbestandsmäßigkeit und Rechtfertigung steuerlicher Diskriminierungen nach EG-Recht," in Schön, W. (Ed.), *GedS Knobbe-Keuk* (1997) 821 *et seq*.

[128]*See* ECJ 15. 10. 1986, 168/85, ECR 1986, 2945, *Commission / Italy* — para. 11; ECJ 11. 6. 1991, C-307/89, ECR 1991, I-2903, *Commission / France* — para. 13; ECJ 25. 7. 1991, C-58/90, ECR 1991, I-4193, *Commission / Italy* — para. 12 *et seq*.; ECJ 17. 11. 1992, C-236/91, ECR 1992, I-5933, *Commission / Ireland* — para. 6; ECJ 26. 1. 1994, C-381/92, ECR 1994, I-215, *Commission / Ireland* — para. 7; ECJ 24. 3. 1994, C-80/92, ECR 1994, I-1019 *Commission / Belgium* — para. 20; ECJ 26. 10. 1995, C-151/94, ECR 1995, I-3685, *Commission / Luxembourg* — para. 18; ECJ 29. 10. 1998, C-185/96, ECR 1998, I-6601, *Commission / Greece* — para. 32; ECJ 18. 1. 2001, C-162/99, ECR 2001, I-541, *Commission / Italy* — para. 33; ECJ 13. 7. 2000, C-160/99, ECR 2000, I-6137, *Commission / France* — para. 23. *Cf.* ECJ 14. 2. 1995, C-279/93, ECR 1995, I-225, *Schumacker* — para. 53 *et seq*.

[129]*See, e.g.,* ECJ 26. 10. 1999, C-294/97, ECR 1999, I-7447, *Eurowings* — para. 43 *et seq*.; ECJ 3. 10. 2002, C- 136/00, ECR 2002, I-8147, *Danner* — para. 56.

[130]*See* article 73d(1)(a) and article 73d(3) before the Treaty of Amsterdam.

[131]*See* for an overview, *e.g.,* Sedlaczek, M., "Der Begriff der Diskriminierung und der Beschränkung — die Kapitalverkehrsfreiheit als konvergente Grundfreiheit des EG-Vertrages," in Lechner, E., C. Staringer, and M. Tumpel (Eds.), *Kapitalverkehrsfreiheit und Steuerrecht* (2000) 27 (51 *et seq*.).

[132]*See, e.g.,* Dautzenberg, N., "Die Kapitalverkehrsfreiheit des EG-Vertrages, der Steuervorbehalt des article 73d EGV und die Folgen für die Besteuerung," *RIW* 1998, 537 (541); Ruppe, H.G., "Die Bedeutung der Kapitalverkehrsfreiheit für das Steuerrecht," in Lechner, E., C. Staringer, and M. Tumpel (Eds.), *Kapitalverkehrsfreiheit und Steuerrecht* (2000) 9 (21 *et seq*.); Staringer, C., "Dividendenbesteuerung und Kapitalverkehrsfreiheit," in Lechner, E., C. Staringer, and M. Tumpel (Eds.), *Kapitalverkehrsfreiheit und Steuerrecht* (2000) 93 (106 *et seq*.); Saß, G., "Zum Schutz von Kapitalbewegungen in der EU gegen steuerliche Diskriminierung," *FR* 2000, 1270 (1272); Staringer, C., "Auslandsdividenden und Kapitalverkehrsfreiheit," *ÖStZ* 2000/119, 26 (28 *et seq*.).

[133]*See* ECJ 6. 6. 2000, C-35/98, ECR 2000, I-4071, *Verkooijen* — para. 42 *et seq*.; *cf.* Opinion AG Kokott 12. 2. 2004, C-242/03, *Weidert and Paulus* — para. 27 *et seq*.

interest, particularly in relation to the cohesion of the tax system.[134]

B. What Does This Mean for Limitation on Benefits Clauses?

Before the open skies decisions, few scholars and practitioners doubted that the LoB clauses would infringe on the freedom of establishment,[135] and since the open skies decisions, no one seriously does.[136] The relevant arguments are straightforward: The freedom of establishment under articles 43 and 48 EC, as opposed to the freedom of capital movement under article 56 EC, is applicable when the right to management of the undertaking concerned is connected with an investment. When assessing whether that determining criterion is met, one consideration is the size of the investment involved. Control can be inferred in the case of a substantial holding[137] of 50 percent or more.[138] Furthermore, it is settled case law that the freedom of establishment is restricted in violation of the EC Treaty when a company suffers adverse tax treatment because its parent company is resident in another member state.[139] The ECJ has frequently dealt with cases in which tax benefits were denied to resident parent or subsidiary companies because their respective counterparts were resident in another member state, and in every case, the ECJ has held that such treatment is an unjustified infringement of the EC Treaty.[140] The same arguments are true regarding the

[134]*Cf.* Cordewener, A., *Europäische Grundfreiheiten und nationales Steuerrecht* (2002) 747 *et seq*.; Flynn, L., "Coming of Age: The Free Movement of Capital Case Law 1993-2002," *CML Rev.* 2002, 773 (793 *et seq*.).

[135]Before the open skies decisions, most authors believed that LoB clauses infringed on the EC Treaty; *see, e.g.*, Eilers, S. and M. Watkins-Brügmann, "Article 28 of the German-U.S. Double Taxation Treaty of 1989: An Appropriate Solution of the Treaty Shopping Problem?" 20 *Tax Planning Int'l Rev.* 15 (19 *et seq*.) (Sept. 1993); Vanistendael, F., "The Limits to the New Community Tax Order," *CML Rev.* 1994, 293 (305 *et seq*.); Doyle, H., "Is Article 26 of the Netherlands-United States Tax Treaty Compatible With EC Law?" *ET* 1995, 14 (14 *et seq*.); Martín-Jiménez, A.J., "EC Law and Clauses on 'Limitation of Benefits' in Treaties With the U.S. After Maastricht and the U.S.-Netherlands Tax Treaty," *EC Tax Rev.* 1995, 78 (78 *et seq*.); Offermanns, R., "Tax Treaties in Conflict With the EC Treaty: The Incompatibility of Anti-Abuse Provisions and EC Law," *EC Tax Rev.* 1995, 97 (97 *et seq*.); Malherbe, J. and O. Delattre, "Compatibility of Limitation on Benefits Provisions With EC Law," *ET* 1996, 12 (12 *et seq*.); Essers, P. and R.H.M.J. Offermanns, "Tax Treaties in Conflict With the EC Treaty: The Incompatibility of Anti-Abuse Provisions and EC Law," 22 *Int'l Tax J.* 69 (72 *et seq*., 76 *et seq*.) (1996); Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus.* 165 (165 *et seq*.) (1997); Kemmeren, E., "The Netherlands," in Essers, P., G. de Bont, and E. Kemmeren (Eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties With EC Law* (1998) 125 (146 *et seq*.); Tumpel, M., "Europarechtliche Besteuerungsmaßstäbe für die grenzüberschreitende Organisation und Finanzierung von Unternehmen," in Pelka, J. (Ed.), *Europa- und verfassungsrechtliche Grenzen der Unternehmensbesteuerung DStJG* 23 (2000) 321 (353 *et seq*.); Terra, B. and P. Wattel, *European Tax Law,* 3rd ed., (2001) 112 *et seq*.; Pistone, P., *The Impact of Community Law on Tax Treaties* (2002) 91 et. seq. However, some authors argued that LoB clauses may either be nondiscriminatory or justified under the rule of reason; *see, e.g.,* Van Unnik, D. and M. Boudesteijn, "The New U.S.-Dutch Treaty and the Treaty of Rome," *EC Tax Rev.* 1993, 106 (106 *et seq*.); Toifl, G., "Austria," in Essers, P., G. de Bont, and E. Kemmeren (Eds.), *The Compatibility of Anti- Abuse Provisions in Tax Treaties with EC Law* (1998) 41 (49 *et seq*.); Avery Jones, J.F., "Flows of Capital Between the EU and Third Countries and the Consequences of Disharmony in European International Tax Law," *EC Tax Rev.* 1998, 95 (103).

[136]*See, e.g.*, Craig, A., A. Rainer, J. Roels, O. Thoemmes, and E. Thomsett, "ECJ Renders Wide-Reaching Decision on German Thin Capitalization Rules," *Tax Notes Int'l*, Dec. 23, 2002, p. 1163; Clark, B., "The Limitation on Benefits Clause Under an Open Sky," *ET* 2003, 22 (22 et seq.); Craig, A., "Open Your Eyes: What the 'Open Skies' Cases Could Mean for the U.S. Tax Treaties With the EU Member States," *BIFD* 2003, 63 (63 *et seq*.); Clark, B., "Limitation on Benefits: Changing Forms in the US-UK Tax Treaty," *ET* 2003, 97; Tumpel, M., "Der Einfluss der

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Footnote 136 continued

Grundfreiheiten des EG-Rechts auf die Doppelbesteuerungsabkommen," *ÖStZ* 2003/243, 154 (156 *et seq*.); Panayi, C., "Open Skies for European tax?" *BTR* 2003, 189 (189 *et seq*.); De Ceulaer, S., "Community Most-Favoured-Nation Treatment: One Step Closer to the Multilateralization of Income Tax Treaties in the European Union?" *BIFD* 2003, 493 (493 *et seq*.); Berner, R. and G. May, "The New U.K.-U.S. Income Tax Treaty Revisited," 32 *Tax Mgm't Int'l* J. 395 (395 *et seq*.) (2003); Oliver, D.B., "Tax Treaties and the Market-State," 56 *Tax L. Rev.* 587 (599 *et seq*.) (2003); Sepho, D., "Does the U.K.-U.S. Tax Treaty Conflict With the EC's Freedom of Establishment Principle?" 32 *Tax Notes Int'l*, Oct. 20, 2003, p. 279; Weiner, J.M., "EU Prepares for Corporate Tax Reform at Rome Conference," 32 *Tax Notes Int'l*, Dec. 8, 2003, p. 913.

[137]ECJ 13. 4. 2000, C-251/98, ECR 2000, I-2787, *Baars* — para. 20 *et seq*.

[138]Opinion AG *Alber* 24. 9. 2002, C-168/01, *Bosal* — para. 31.

[139]*See* for a discussion of these situations, *e.g.,* Kofler, G. "Bosal: Abzugsverbot für Beteiligungsaufwendungen verstößt gegen die im Lichte der Niederlassungsfreiheit ausgelegte Mutter-Tochter-RL," *ÖStZ* 2003/1175, 554 (554 *et seq*.).

[140]In the *ICI* case (ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI*) the Court evaluated a British rule under which the utilization of losses of subsidiaries, which were held by an intermediate holding company, by the parent company was only possible in the case in which the holding company mainly held British subsidiaries. In the *X AB and Y AB* case (ECJ 18. 11. 1999, C-200/98, ECR 1999, I-8261, *X AB und Y AB*) the ECJ was confronted with Swedish provisions under which certain tax benefits for intercompany payments were not available in cases in which foreign subsidiaries were involved; the Court held that the differentiation based on the residence of a subsidiary is a forbidden discrimination. In the *Baars* case (ECJ 13. 4. 2000, C-251/98, ECR 2000, I-2787, *Baars*), the Court had to deal with a Dutch provision that granted tax benefits for shareholders of Dutch companies but denied benefits to shareholders of other EU companies (*see also* ECJ 6. 6. 2000, C-35/98, ECR 2000, I-4071, *Verkooijen*).

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freedom of capital movement under article 56 EC, because that freedom covers investment in foreign corporations and forbids the restriction of those investments, including measures that make an investment less attractive.[141]

Because the fundamental freedoms of the EC Treaty also apply to provisions in tax treaties, the aforementioned argument applies to LoB clauses. The ownership clauses in LoB provisions preclude benefits for corporations whose shareholders are residents of other member states. Those provisions restrict the freedom of establishment of EU residents who want to set up a subsidiary in the member state that has concluded the DTC and therefore constitute covert discrimination.[142] After the open skies judgments, it is clear that member states must conclude international treaties in light of their obligations under EC law, that the unwillingness of the third state to negotiate will not justify a discrimination, and that the source of a discrimination can also lie in the mere entering into of such a treaty. From those decisions it can be concluded that it is not relevant which treaty partner applies the LoB provision, rather than whether that application produces discriminatory effects for residents of other member states. Once it is identified that an LoB amounts to a covert discrimination, such discrimination can be justified only if the provision in question pursues a legitimate aim compatible with the EC Treaty, is justified by pressing reasons of public interest,[143] and is of such a nature as to ensure achievement of the aim in question and not go beyond what was necessary for that purpose.[144]

That conclusion is not weakened by the fact that the other tests under an LoB clause might, separately, be nondiscriminatory or justified under the rule of reason.[145] Even one discriminatory test — for example, the ownership test — renders the whole LoB provision discriminatory, because it restricts a company's choice of available tests.[146] In other words, when a corporation is wholly owned by a resident of another member state, that corporation will not be able to claim treaty benefits unless it meets another test, such as the activity or the headquarter test, or unless it is granted discretionary relief by the U.S. competent authority.[147] Because wholly EU-owned holding companies do not usually meet those tests and therefore generally fail to qualify under treaties between the United States and a member state, those companies face higher U.S. withholding taxes on dividends, interest, and royalties than companies owned by residents of the contracting member state would. In this case, companies held by residents of other EU member states would generally be comparable to similarly situated companies held by residents of the contracting member state and to treat them differently would be discrimination. For example, it is discriminatory that a wholly U.K.-owned U.K. company, which would not meet the active business test under article 23 U.S.-U.K. DTC, could benefit from the U.K.-U.S. DTC, while a wholly EU-owned U.K. company, which also does not fulfill the active business test, is denied those benefits. Given that comparison, it is irrelevant whether the active business test under article 23 U.K.- U.S. DTC is in compliance with EC law.

Footnote 140 continued

The Court confirmed that case law in the *Metallgesellschaft und Hoechst* case (ECJ 8. 3. 2001, C-397/98 and C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst*), in which the option to a group relief and the connected renunciation of advance corporate tax payments was only available if the parent company and subsidiary were residents of the United Kingdom; in that case, the ECJ held that the residency of the parent company must not lead to an unequal taxation of the subsidiary its member state of residence. Furthermore, in the *Lankhorst-Hohorst* case (ECJ 12. 12. 2002, C-324/00, ECR 2002, I-11779, *Lankhorst-Hohorst*), the ECJ held that German thin capitalization rules that only apply for cross-border payments are an infringement of the EC Treaty. Finally, as the Court held in the *Bosal* case (ECJ 18. 9. 2003, C-168/01, *Bosal*), the difference between the deductibility of financing costs for domestic subsidiaries and those for subsidiaries resident in other member states does not comply with EC law.

[141]*See* Sedlaczek, M., "Capital and Payments: The Prohibition of Discrimination and Restrictions," *ET* 2000, 14 (14 *et seq*.). However, note that the freedom of capital movement — although under some restrictions as set forth in articles 57, 59, and 60 EC — also covers investments from third-country investors in the EU; therefore, article 56(1) EC potentially expands the territorial scope well beyond the EU or EEA.

[142]For other discriminatory features of LoB clauses, *see supra* I.C.

[143]*See, e.g.,* ECJ 28. 1. 1992, C-204/90, ECR 1992, I-249, *Bachmann* — para. 21 *et seq*.; ECJ 28. 1. 1992, C-300/90, ECR 1992, I-305, *Commission / Belgium* — para. 14 et seq.; ECJ 27. 6. 1996, C-107/94, ECR 1996, I-3089, *Asscher* — para. 49 *et seq*.; ECJ 3. 10. 2002, C-136/00, ECR 2002, I-8147, *Danner* — para. 33 *et seq*. and para. 44 *et seq*.

[144]ECJ 15. 5. 1997, C-250/95, ECR 1997, I-2471, *Futura Participations* — para. 26; ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 49.

[145]*See* for possible examples Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (198).

[146]*See, e.g.,* Eilers, S. and M. Watkins- Brügmann, "Article 28 of the German-U.S. Double Taxation Treaty of 1989: An Appropriate Solution of the Treaty Shopping Problem?" 20 *Tax Planning Int'l Rev.* 15 (21) (Sept. 1993); Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus.* 165 (207 *et seq*.) (1997); Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (198).

[147]*See* Van Unnik, D. and M. Boudesteijn, "The New U.S.-Dutch Treaty and the Treaty of Rome," *EC Tax Rev.* 1993, 106 (111).

C. The Implications of Article 307 EC for New Member States

1. Preexisting Treaties of EU Member States and EC Law

Regarding those member states whose treaties with the United States entered into force before their accession to the EU,[148] a question arises about the relationship between those preexisting treaties and the obligations of the member states under the EC Treaty. Under the principles of customary international law, as laid down in article 30(4) of the Vienna Convention on the Law of Treaties of 1969,[149] the mutual rights and obligations between two states derived from an earlier bilateral treaty prevail over those derived from a later multilateral treaty regarding the same subject matter as covered by the earlier bilateral treaty when only one party of the former treaty is party to the latter treaty. However, international customary law also provides the possibility to explicitly subordinate the application of the earlier treaty to the latter, or vice versa, by means of specific clauses.[150]

A subordination clause preserving the *status quo ante* and the *status juris communitatis quo ante*, respectively, is represented by article 307(1) EC, under which the "rights and obligations arising from agreements concluded before 1 January 1958 or, for acceding States, before the date of their accession, between one or more member states on the one hand, and one or more third countries on the other, shall not be affected by the provisions of this Treaty." Therefore, article 307(1) EC recognizes the customary law that member states must not violate provisions of treaties that were applicable when the Communities were founded or when the respective member state acceded to the EC or EU. Viewed from another perspective, article 307(1) EC attempts to protect the legitimate interests of third countries that have concluded agreements under international law with states that later became members of the Community, by providing, in accordance with article 30(4) of the Vienna Convention, that member states remain bound by obligations in preexisting treaties.[151] The ECJ has also repeatedly held that article 307 EC is of general scope and therefore applies to any international agreement, irrespective of subject matter, which is capable of affecting the application of the EC Treaty.[152] Therefore, article 307 EC is applicable to DTCs.[153]

Returning to the initial issue of LoB clauses in DTCs, we can conclude that the "rights and obligations" under preexisting DTCs between new member states and the United States are protected by the EC Treaty by virtue of article 307(1) EC;[154] therefore, the right granted to the United States to deny treaty benefits under an LoB clause is not influenced by the later accession of the U.S.'s treaty partner to the EU. However, provisions of those DTCs, including LoB clauses, may conflict with EC law. The tension between the safeguarding of preexisting treaties and incompatibility of portions of those treaties with EC law is

[148]These countries include new member states Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia, which all acceded to the EU May 1, 2004, and, with the exception of Hungary, have an LoB clause in their respective DTC with the United States; see for an overview of related timing issues Appendix III. For the legal relevance of the effective date of the treaty as opposed to the signing of the treaty, for purposes of article 307 EC, *see* Manzini, P., "The Priority of Preexisting Treaties of EC Member States Within the Framework of International Law," *EJIL* 2001, 781 (785 *et seq*.).

[149]UN Treaty Series, Vol. 1155, 331. Although the Vienna Convention on the Law of Treaties of 1969 is only related to the law of treaties concluded between states, and not to those concluded between states and international organizations, it is commonly assumed that the Vienna Convention codified the customary international law; *see, e.g.,* Manzini, P., "The Priority of Preexisting Treaties of EC Member States Within the Framework of International Law," *EJIL* 2001, 781 (781).

[150]See article 30(2) of the Vienna Convention; *cf.* Manzini, P., "The Priority of Preexisting Treaties of EC Member States Within the Framework of International Law," *EJIL* 2001, 781 (782).

[151]*See* ECJ 27. 2. 1962, 10/61, ECR 1961, 1, *Commission/Italy*; ECJ 14. 10. 1980, 812/79, ECR 1980, 2787, *Burgoa* — para. 8; ECJ 2. 8. 1993, C-158/91, ECR 1993, I-4287, *Levy* — para. 12; ECJ 28. 3. 1995, C-324/93, ECR 1995, I-563, *Evans Medical and Macfarlan Smith* — para. 27; ECJ 14. 1. 1997, C-124/95, ECR 1997, I-81, *Centro-Com* — para. 56; ECJ 4. 7. 2000, C-62/98, ECR 2000, I-5171, *Commission/Portugal* — para. 44; ECJ 4. 7. 2000, C-84/98, ECR 2000, I-5215, *Commission/Portugal* — para. 53.

[152]*See, ex multis*, ECJ 14. 10. 1980, 812/79, ECR 1980, 2787, *Burgoa* — para. 6; EJC 2. 8. 1993, C-158/91, ECR 1993, I-4287, *Levy* — para. 11; *cf.* Petersmann, E.U. in H. van der Groeben, J. Thiesing, and C.D. Ehlermann, (Eds.), *Kommentar zum EU-/EG-Vertrag,* 5th ed., (1997) article 234 para. 1.

[153]*See, e.g.,* Lang M., "Die Bindung der Doppelbesteuerungsabkommen an die Grundfreiheiten des EU-Rechts," in W. Gassner, M. Lang, and E. Lechner (Eds.), *Doppelbesteuerungsabkommen und EU-Recht* (1996) 25 (31).

[154]It may be questioned if it should be considered that some of the new member states entered into an LoB provision in their tax treaties with the United States after their application for EU membership and after the announcement or the start of the negotiation process (see Appendix III). One could argue that some kind of preaccession obligations arise from the moment of the application or the start of negotiations and that future member states must not enter into obligations with third parties interfering with their future obligations as EU member states. However, that view does not have much legal ground, since an obligation not to defeat the object and purpose of a treaty before its entry into force only exists after the signing of the treaty. That principle is laid down in article 18 of the Vienna Convention on the Law of Treaties of 1969. Therefore, no additional legal arguments can be derived from the fact that the DTCs between the United States and some of the new member states entered into force after the start of accession negotiations. However, the preaccession Europe Agreements may be relevant in evaluating some of these issues; *see* infra III.C.3.

explicitly addressed by a *pactum de agendo* provided in article 307(2) EC.

2. Article 307(2) EC: Consequences of Incompatibility of Preexisting Treaties of EU Member States and the EC Treaty

Article 307(2) EC states that to the extent preexisting treaties are incompatible with the EC Treaty, "the Member State or States concerned shall take all appropriate steps to eliminate the incompatibilities established. Member states shall, where necessary, assist each other to this end and shall, where appropriate, adopt a common attitude." Although that provision requires compliance with the EC Treaty, the consequences of failing to do so are limited insofar as article 307(2) EC does not give an explicit deadline for compliance. On the other hand, the principle of uniform application of EC law requires that a situation of incompatibility should not be allowed to continue. Read against the backdrop provided by that principle, article 307(2) EC does impose an obligation to achieve a result.[155] Article 307(2) EC must therefore be seen as a commitment by the member states to take action, while observing the principle of *pacta sunt servanda*, to ensure that there are no circumstances in which implementation of EC law would be blocked by the existence of agreements with third countries.

The principal course of action therefore is an adjustment of an incompatible preaccession agreement by recourse to diplomatic means. Nevertheless, regarding the clause that "all appropriate steps to eliminate the incompatibilities established" must be taken, the ECJ has recently given a fairly strict interpretation of article 307(2) EC. If a member state encounters difficulties that make an adjustment of an inconsistent agreement impossible, it is settled case law that, insofar as a denunciation of that agreement is possible under international law,[156] an obligation of the member state "to denounce that agreement cannot be excluded."[157] In that regard, neither the existence of a difficult political situation in a third state (for example, a state of war, constant tension, or disintegration) nor foreign policy interests can justify a continuing failure on the part of a member state to fulfill its obligations under the EC Treaty.[158] Nevertheless, denunciation should be regarded as a last resort to be used after a reasonable period has elapsed and less severe procedures have proved unsuccessful to achieve the result required by EC law. As the ECJ points out, a difficult political situation in the third country may provide a temporary excuse.[159] On the other hand, the eventual failure to adjust an incompatible agreement by diplomatic means is a failure to fulfill obligations under EC law. Many issues remain unsolved by the ECJ, especially whether there is an obligation to denounce the whole agreement when only one of its clauses is of a contentious nature.[160] It also remains unclear what effect article 6(10)(2) of the Accession Act[161] has on that question; the provision indicates that a new member state that encounters difficulties in adjusting an incompatible preaccession agreement can, according to

[155] *See* ECJ 4. 7. 2000, C-62/98, ECR 2000, I-5171, *Commission/Portugal* — para. 49; ECJ 4. 7. 2000, C-84/98, ECR 2000, I-5215, *Commission/Portugal* — para. 58; Joined Opinion AG Mischo 20. 10. 1999, C-62/98 and C-84/98, ECR 2000, I-05171, *Commission/Portugal* — para. 58; *see also* Pistone, P., *The Impact of Community Law on Tax Treaties* (2002) 89.

[156] The legal possibility of denunciation of an agreement is an important idea of article 307(1) EC. Article 307 EC requires that a member state must respect the rights of third countries under a precommunity agreement and perform its obligations thereunto (*see, e.g.,* ECJ 4. 7. 2000, C-62/98, ECR 2000, I-5171, *Commission/Portugal* — para. 45). If a treaty enables the parties to denounce it, an eventual denunciation of the member state would not encroach on the rights of the third-country treaty partner and would therefore be an option under article 307(2) EC. Under article 56(1) of the Vienna Convention, the denunciation of or withdrawal from a treaty containing no provision regarding termination is generally not possible unless it is established that

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Footnote 156 continued

the parties intended to admit the possibility of denunciation or withdrawal. Also, a right of denunciation or withdrawal may be implied by the nature of the treaty. However, that issue will rarely arise in the area of DTCs because those treaties usually contain a termination clause; *see, e.g.,* article 31 of the OECD Model Convention 2003; article 29 of the 1996 U.S. Model Income Tax Convention, *96 TNI 186-16*; and the Treasury Department Technical Explanation of the 1996 United States Model Income Tax Convention (article 29), *96 TNI 186-17*.

[157] ECJ 4. 7. 2000, C-62/98, ECR 2000, I-5171, *Commission/Portugal* — para. 34, 49; ECJ 4. 7. 2000, C-84/98, ECR 2000, I-5215, *Commission/Portugal* — para. 40, 58; *cf.* Manzini, P., "The Priority of Preexisting Treaties of EC Member States Within the Framework of International Law," *EJIL* 2001, 781 (790 *et seq*.); *see also* ECJ 14. 9. 1999, C-170/98, ECR 1999, I-5493, *Commission/Belgium* — para. 42.

[158] ECJ 14. 9. 1999, C-170/98, ECR 1999, I-5493, *Commission/Belgium* — para. 42; ECJ 4. 7. 2000, C-62/98, ECR 2000, I-5171, *Commission/Portugal* — paras. 39, 40 *et seq*.; ECJ 4. 7. 2000, C-84/98, ECR 2000, I-5215, *Commission/Portugal* — paras. 48, 49 *et seq*.

[159] *See also* Hillion. C., Case C-62/98 *Commission of the European Communities v. Portugal*, *CML Rev*. 2001, 1269 (1282).

[160] Although the ECJ ignored that point in *Commission/Belgium* (ECJ 14. 9. 1999, C-170/98, ECR 1999, I-5493, *Commission/Belgium*), the Commission acknowledged the problems of denunciation in circumstances in which only part of an agreement is incompatible with EC law; *see* Hillion. C., Case C-62/*98 Commission of the European Communities v. Portugal, CML Rev*. 2001, 1269 (1281).

[161] The act defines the accession conditions of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, and the Slovak Republic and the adjustments to the treaties on which the European Union is founded, OJ L 236/33 (23. 9. 2003).

the terms of the agreement, withdraw from any such agreement.[162]

From that overview, two issues regarding LoB clauses in DTCs with the United States arise. First, article 307(2) EC is undoubtedly addressed to member states and is therefore not directly applicable to taxpayers, who therefore may not assert the failure to remove incompatibilities before a domestic court.[163] Second, and less clear, the effects of article 307(2) EC on a member state with regard to an LoB clause in a preaccession DTC with the United States and possible implications for the issue of remedies — actions for damages against the contracting member state — have to be examined. There seems to be little doubt that article 307(2) EC imposes an obligation on each member state to act so that the entitlement to benefits under DTCs with the United States complies with EC law.[164] But because compliance cannot be achieved simply by unilateral measures of a member state[165] — in contrast to the *Saint-Gobain* case[166] — adjustment of a preaccession DTC with the United States by recourse to diplomatic means seems to be the first option. However, if the difficulty in eliminating incompatibilities is due to the inferior negotiating power of the member state compared to the United States, the ongoing detriment to residents of other EU member states must be accepted temporarily without any liability of the respective member state.[167] That results from the systematic approach employed by article 307 EC: Article 307(1) gives the respective member state a right not to comply with EC law in order to meet a treaty obligation toward a third party; however, that right is temporary under article 307(2) EC.[168]

To what extent — and for what period of time — that argument can be upheld against the background of the aforementioned case law of the ECJ to article 307 EC is unclear. The only relevant statement is found in the opinion of Advocate General Antonio Tizzano in the open skies cases.[169] Tizzano argued that it was not enough if member states attempt "to renegotiate the clause in question with the United States authorities, with a view to eliminating its alleged incompatibility with Community law," but are met with a firm refusal by those authorities. He concluded that article 307(2) was not fulfilled if member states undisputedly did not "adopt a common attitude vis-à-vis the United States," and did not "take steps to assist each other with a view to bringing the other contracting parties to agree to an amendment of the nationality clause so as to bring it into line with Community law." Furthermore, Tizzano found that it was not enough if member states, in the course of negotiations, did not inform "the United States of America that, if the nationality clause were not amended," the respective member states "might ultimately find themselves in a situation in which it would be necessary to denounce the agreements." As the advocate general indicated, the last resort would be the denunciation of a DTC.[170] But because the whole

[162]Article 6(10)(2) of the Accession Act reads: "To the extent that agreements between one or more of the new Member States on the one hand, and one or more third countries on the other, are not compatible with the obligations arising from this Act, the new Member State shall take all appropriate steps to eliminate the incompatibilities established. If a new Member State encounters difficulties in adjusting an agreement concluded with one or more third countries before accession, it shall, according to the terms of the agreement, withdraw from that agreement." According to article 2 of the Accession Act, *inter alia*, the EC Treaty shall be binding on the new member states from the date of accession, which amounts to "obligations arising from this Act" within the meaning of article 6(10)(2).

[163]*See* Eicker, K., "Cases *Hoechst/Metallgesellschaft* before the European Court of Justice," *Intertax* 1999, 173 (175); Pistone, P., *The Impact of Community Law on Tax Treaties* (2002) 89. For the similar issue of article 293 EC, under which the member states shall, so far as is necessary, enter into negotiations with each other to secure for the benefit of their nationals "the abolition of double taxation within the Community," the ECJ has held that the provision does not have direct effect; *see* ECJ 12. 5. 1998, C-336/96, ECR 1998, I-2793, *Gilly* — para. 14 *et seq*.

[164]*See also* Pistone, P., *The Impact of Community Law on Tax Treaties* (2002) 91.

[165]*See* Petersmann, E.U. in H. van der Groeben, J. Thiesing, and C.D. Ehlermann (Eds.), *Kommentar zum EU-/EG- Vertrag,* 5th ed., (1997) article 234 para. 8; *cf.* Lang, M., "Die Bindung der Doppelbesteuerungsabkommen an die Grundfreiheiten des EU-Rechts," in W. Gassner, M. Lang, and E. Lechner (Eds.), *Doppelbesteuerungsabkommen und EU-Recht* (1996) (31 *et seq*.).

[166]ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain*.

[167]*See* Pistone, P., *The Impact of Community Law on Tax Treaties* (2002) 92; *cf.,* Farmer, P., "EC Law and Direct Taxation — Some Thoughts on Recent Issues," *EC Tax J.* 1995/96, 105.

[168]*See* Petersmann, E.U. in H. van der Groeben, J. Thiesing, and C.D. Ehlermann (Eds.), *Kommentar zum EU-/EG-Vertrag,* 5th ed., (1997) article 234 para.12; Malherbe, J. and O. Delattre, "Compatibility of Limitation on Benefits Provisions with EC Law," *ET* 1996, 12 (14); Lang, M. "Die Bindung der Doppelbesteuerungsabkommen an die Grundfreiheiten des EU-Rechts," in W. Gassner, M. Lang, and E. Lechner, (Eds.), *Doppelbesteuerungsabkommen und EU-Recht* (1996) 25 (31).

[169]Joined opinion of AG Tizziano 31. 1. 2002, C-466/98 *et al*., ECR 2002, I-9427, *Commission/U.K. et al. (open skies)* — para. 143 *et seq*.

[170]The denunciation of the only the contentious LoB clause is not an option: Under customary international law, as provided in article 44 of the Vienna Convention, the denunciation of a treaty may be exercised only with respect to the whole treaty. If, however, the grounds for the denunciation relates solely to particular clauses, it may then be invoked only for those clauses if several prerequisites are met; one of those is that "it appears from the treaty or is otherwise established that acceptance of those clauses was not an essential basis of the consent of the other party or parties to be bound by the treaty as a whole." In light of that and because the United States was until now unwilling in the negotiations of DTCs with EU member states to draft LoB provi-

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interpretation of article 307 EC is based on evolving judicial doctrines, the issue must finally be clarified by the ECJ. In that context, the Court will have to consider that the denunciation of a DTC would produce an even worse tax result for residents of the respective member state, without improving the tax result for residents of other member states.

3. Europe Agreements: No Way Out?

Before accession to the EU as of May 1, 2004, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia entered into so-called Europe Agreements with the EC and its member states.[171] Those agreements provided the framework for bilateral relations between the EC and its member states on the one hand and the accessing partner countries on the other. They aimed progressively to establish a free-trade area between the EU and the partner countries over a given period and to prepare their accession to the EU.[172]

The existence of Europe Agreements may, however, undermine any argument by Estonia, Latvia, Lithuania, and Slovenia based on article 307 EC, because the agreements with those states took effect before the effective date of their respective DTCs with the United States. Therefore, the inquiry of an infringement of the EC Treaty by an LoB clause may be transferred from the EC Treaty to the respective Europe Agreement itself. All those Europe Agreements include, among other reciprocal benefits and obligations, an article under which the respective acceding partner country shall, *inter alia*, grant from the entry into force of the respective Europe Agreement[173] the so-called secondary freedom of establishment, that is, national treatment regarding the establishment of EU companies in the form of taking up economic activities by means of the setting up of subsidiaries and branches in its territory, and regarding subsidiaries and branches of EU companies established in its territory.[174] The agreements also provide that companies that are controlled and exclusively owned jointly by companies or nationals of the partner country and Community companies or nationals shall also be beneficiaries of those provisions.[175]

After comparing the goals and context of those provisions of the Europe Agreements with those of the EC Treaty, there are no grounds for giving to those provisions a meaning different from that of articles 43 and 48 EC regarding the secondary freedom of establishment in the host country.[176] Under settled ECJ case law, it is also clear that those provisions in the Europe

Footnote 170 continued

sions in complete recognition of the EU membership of its treaty partners (*see, e.g.,* DeCarlo, J., A.W. Granwell, and S. van Weeghel, "An Overview of the Limitation on Benefits Article of the New Netherlands-U.S. Income Tax Convention," 22 *Tax Mgm't Int'l J.* 271 (280) (1993)), the latter clause most likely is not met; *see generally* Troup, E., "Of Limited Benefits: Article 26 of the new U.S./Netherlands Double Tax Treaty considered," *BTR* 1993, 97 (104).

[171]*See* the Europe Agreements with the Czech Republic, OJ L 360, 31. 12. 1994, 2 *et seq*. (EA Czech Republic); Estonia, OJ L 068, 9. 3. 1998, 3 *et seq*. (EA Estonia); Hungary, OJ L 347, 31. 12. 1993, 2 *et seq*. (EA Hungary); Latvia, OJ L 026, 2. 2. 1998, 3 *et seq*. (EA Latvia); Lithuania, OJ L 051, 20. 2. 1998, 3 *et seq*. (EA Lithuania); Poland, OJ L 348, 31. 12. 1993, 2 *et seq*. (EA Poland); Slovakia, OJ L 359, 31. 12. 1994, 2 *et seq*. (EA Slovakia), and Slovenia, OJ L 051, 26. 2. 1999, 3 et seq. (EA Slovenia). *See* for a comparative overview of these agreements, *e.g.,* Ingles, K., "The Europe Agreements Compared in the Light of Their Pre-Accession Reorientation," *CML Rev.* 2000, 1173 (1173 *et seq*.).

[172]*See, e.g.,* Ingles, K., "The Europe Agreements Compared in the Light of Their Pre-Accession Reorientation," *CML Rev.* 2000, 1173 (1175 *et seq*.)

[173]Although the EAs, except the EA Estonia, provide for transitional phases, which also apply to association under the title on establishment (*see, e.g.,* Ingles, K., "The Europe Agreements Compared in the Light of Their Pre-Accession Reorientation," *CML Rev.* 2000, 1173 (1192 *et seq*.)), they have no effect on the establishment of companies that is guaranteed from the entry into force of the respective Europe Agreement (*see* article 43(2) EA Estonia; article 44(2) EA Latvia; article 44(2) EA Lithuania; article 45(1) EA Slovenia).

[174]*See* article 43(2) EA Estonia; article 44(2) EA Latvia; article 44(2) EA Lithuania; article 45(1) EA Slovenia. Limitations of those rights must be justified on the grounds of public policy, public security, or public health. The agreements usually also provide that, subject to the above-mentioned provisions, the respective partner country may regulate the establishment and operation of companies and nationals on its territory, but only insofar as the regulations do not discriminate against companies and nationals of the other party in comparison with its own companies and nationals. *See* article 46(1) EA Estonia; article 47(1) EA Latvia; article 47(1) EA Lithuania; article 48(1) EA Slovenia. Because an EC company is defined as a company set up in accordance with the laws of a member state and having its registered office or central administration or principal place of business in the territory of the community, however, the exclusion of subsidiaries from national treatment with regard to an LoB clause seems infeasible. Finally, the exclusion would probably not qualify as a regulation of the establishment and operation of companies within the meaning of the aforementioned provisions. Although irrelevant for the issues at stake, all EAs contain a clause allowing the partner state to derogate from the establishment provisions in respect of EC companies and nationals wanting access to sensitive industries, for example, industries facing serious difficulties, particularly in which they entail serious social problems in the partner state.

[175]*See* article 56 EA Estonia; article 57 EA Latvia; article 57 EA Lithuania; article 58 EA Slovenia.

[176]*See, e.g.,* ECJ 29. 1. 2002, C-162/00, ECR 2002, I-01049, *Pokrzeptowicz-Meyer* — para. 39; for the case of national immigration clauses in EAs regarding the migration of individuals, *see, e.g.,* Van Ooik, R., "Freedom of Movement of Self-Employed Persons and the Europe Agreements," *Europ. J. Migr. & L.* 2002, 377 (382 *et seq*.).

Agreements must be construed as establishing a precise and unconditional principle that is sufficiently operational to be applied by a national court and that is capable of governing the legal position, *inter alia*, of EU companies. The provisions have direct effect and give EU companies the right to invoke them before the courts of the respective partner state.[177] It may be concluded that LoB provisions infringe on the Europe Agreements for the same reasons they infringe on articles 43 and 48 EC.[178] Based on those considerations, one may argue that the respective member states cannot rely on article 307 EC for temporary relief from liability for violating EC law in their DTCs with the United States, because the obligations regarding the secondary freedom of establishment under the Europe Agreements existed before their accession to the EU. The relevant date for the timing issue of article 307 EC therefore seems to be the entry into force of the respective Europe Agreement and not the accession of the respective partner state to the EU. Another interpretation of article 307 EC would frustrate the aim of the preaccession phase, because a new member state would receive a beneficial position under article 307 EC although, and because, it neglected its obligations under the respective Europe Agreement by concluding an LoB clause in a DTC with the United States prior to accession to the EU.

It seems that Estonia, Latvia, Lithuania, and Slovenia have failed to fulfill their obligations under the Europe Agreements and — based on the idea that the entry into force of those agreements is decisive — may not rely on article 307 EC to safeguard LoB clauses in their DTCs with the United States. The last resort, however, may lie in an exit clause for tax purposes that all of those agreements contain: The Europe Agreements shall not be construed to prevent the adoption or enforcement by the parties of any measure aimed at preventing the avoidance or evasion of taxes pursuant to the tax provisions of agreements to avoid double taxation and other tax arrangements or to avoid domestic fiscal legislation.[179] Whether those provisions in the Europe Agreements eventually immunize LoB clauses in the treaties between the United States and Estonia, Latvia, Lithuania, and Slovenia is unclear. Although the purpose of LoB clauses is to prevent treaty shopping — and although they may be viewed as a "measure aimed at preventing the avoidance or evasion of taxes" — LoB clauses most likely would not qualify as such if the strict ECJ requirements regarding a purported "treaty shopping" justification of an infringement of a fundamental freedom of the EC Treaty were also applied to those clauses in the Europe Agreements.[180] It may also be questioned whether preventing the avoidance of U.S. taxes, as opposed to taxes of the partner states, is covered by those provisions.

D. Do Derivative Benefits Solve the Problem?

1. The Concept of Derivative Benefits

The argument has been made that a derivative benefits concept could put LoB provisions in compliance with the obligations of member states under the EC Treaty.[181] Before assessing that argument, it's necessary to give an overview of the breadth and, more importantly, the limitations, of that concept. A derivative benefits test entitles a company that is a resident in a contracting state 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 would have been entitled to the same benefit if the income in question flowed directly to that owner. The idea behind the derivative benefits concept is that treaty benefits pursuant to a DTC between two countries should also be available to a company owned by residents of a third country, provided the treaty benefits are no richer than those residents would enjoy if they earned the respective income directly rather than through the intervening company.[182] The experimental use of a derivative benefits concept in U.S. treaty policy is logical against the treaty-shopping background from a source country's point of view, because it demonstrates that the intermediate jurisdiction — that is, the company's country of residence —

[177] *See* also Van den Hurk, H., "Does the Reach of the European Court of Justice Extend Beyond the European Union?" *BIFD* 2002, 275 (279); *see* for the reverse situation, *e.g.,* ECJ 27. 9. 2001, C-63/99, ECR 2001, I-6369, *Gloszczuk* — para. 29 *et seq*.; ECJ 27. 9. 2001, C-257/99, ECR 2001, I-6557, *Barkoci and Malik* — para. 30 *et seq*.; ECJ 20. 11. 2001, C-268/99, ECR 2001, I-08615, *Jany* — para. 25 *et seq*.; *cf.* Van Ooik, R., "Freedom of Movement of Self- Employed Persons and the Europe Agreements," *Europ. J. Migr. & L.* 2002, 377 (380 *et seq*.).

[178] *Supra* III.B.

[179] Article 57(2) EA Estonia; article 58(2) EA Latvia; article 58(2) EA Lithuania; article 59(2) EA Slovenia.

[180] *Infra* III.F.

[181] *See, e.g.*, Vanistendael, F., "The Limits to the New Community Tax Order," *CML Rev.* 1994, 293 (306 *et seq*.); *see* Martín-Jiménez, A.J., "EC Law and Clauses on 'Limitation of Benefits' in Treaties with the U.S. After Maastricht and the U.S.-Netherlands Tax Treaty," *EC Tax Rev.* 1995, 78 (86); Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus.* 165 (212 *et seq*.) (1997); Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (198).

[182] *See, e.g.,* Streng, W.P., "'Treaty Shopping': Tax Treaty 'Limitation on Benefits' Issues," 15 *Hous. J. Int'l L.* 1 (43 *et seq*.) (1992); Rosenbloom, H.D., "Derivative Benefits: Emerging U.S. Treaty Policy," *Intertax* 1994, 83 (83); Cohen, H.J., L.A. Pollack, R. Molitor, "Analysis of the New U.S.-Luxembourg Income Tax Treaty," 25 *Tax Mgm't Int'l J.* 403 (416 *et seq*.) (1996).

does not offer any special benefit the investors could not otherwise obtain, which in turn disproves that the chosen structure was motivated by treaty benefits.[183]

2. The Scope of the Derivative Benefits Provisions in Treaties Between the United States and EU Member States

The first derivative benefits test in a treaty between the United States and an EU member state was article 26(4) of the Netherlands-United States DTC, under which a Netherlands company, not otherwise entitled to treaty benefits under the other objective tests, may be entitled to the benefits of the DTC with respect to dividends, branch tax, interest, and royalties[184] if that company meets an ownership test and a base reduction test. Similar provisions, varying widely in detail, are contained in the treaties with France, Luxembourg, the United Kingdom, Denmark, and Ireland.[185] It may be noted that the derivative benefits clause in the latter four treaties is not limited to certain categories of income — such as dividends, interest, or royalties — as it is in the treaties with the Netherlands and France.

In the case of the Netherlands-United States DTC, as it is currently in force,[186] to qualify under the derivative benefits clause, a resident company must meet an ownership test and a base reduction test, both of which consider the Dutch membership to the EU. Regarding ownership, the derivative benefits test has two requirements.[187] First, over 30 percent of the vote and value of the company's shares must be owned directly or indirectly by any number of qualified persons resident in the contracting member state;[188] in other words, a third-state investor will be unable to claim benefits for his wholly owned Netherlands company. Second, over 70 percent of all the shares must be owned directly or indirectly by any number of qualified persons or by residents of EU member states.[189] The latter category of "good" owners includes persons that meet the three requirements of article 26(8)(i) of the treaty between the United States and the Netherlands.[190] The person would be considered a resident of any such member state under the residence provision of the Netherlands-United States DTC,[191] entitled to the benefits of the DTC under the principles of article 26(1) Netherlands-United States DTC, applied as if that member state were the U.S.'s treaty partner,[192] and entitled to the benefits of the DTC between that

[183]*See* Bennett, M.C. et. al., "A Commentary to the United States-Netherlands Tax Convention," *Intertax* 1993, 165 (203); Bennett, M. C., "The U.S.-Netherlands Tax Treaty Negotiations: A U.S. Perspective," *BIFD* 1991, 3 (7). However, from a residence country's perspective, the derivative benefits concept may cause distortions for the investor's country of residence and the intermediate jurisdiction, because it does not consider national taxation in those countries. Therefore, the residence country's taxing interest may be frustrated by a derivative benefits concept in the DTC between the intermediate jurisdiction and the source country; *cf.* Rosenbloom, H.D., "Derivative Benefits: Emerging U.S. Treaty Policy," in Alpert, H.H. and K. van Raad (Eds.), "Essays on International Taxation," 15 *Series on International Taxation* (1993) 335 (337 *et seq*.); Rosenbloom, H.D., "Derivative Benefits: Emerging US Treaty Policy," *Intertax* 1994, 83 (84 *et seq*.).

[184]In other words, the derivative benefits clause of article 26(4) Netherlands-United States DTC does not help companies qualify for permanent establishment or nondiscrimination protection; *see, e.g.,* Bennett, M.C. et. al., "A Commentary to the United States-Netherlands Tax Convention," *Intertax* 1993, 165 (204); Bennett, M. C. et al., *Commentary to the U.S.-Netherlands Income Tax Convention* (1995) article 26-121.

[185]Article 30(4) France-United States DTC; article 24(4) Luxembourg-United States DTC; article 23(3), (7)(d) United Kingdom-United States DTC; article 22(4) Denmark-United States DTC; article 23(5) Ireland-United States DTC.

[186]On March 8, 2004, the United States and the Netherlands signed an amending protocol to the Netherlands-United States DTC that provides for major changes in the LoB provision, especially the derivative benefits clause, but the protocol is not in force yet; the new version of the LoB clause is reminiscent of article 23 United Kingdom-United States DTC.

[187]So-called 30/70 Netherlands/EC ownership test; *see also* Bennett, M.C. et al., *Commentary to the U.S.-Netherlands Income Tax Convention* (1995) article 26-114 *et seq*.

[188]*See* article 26(4)(a)(i) Netherlands-United States DTC; similar article 30(4)(a) France-United States DTC.

[189]*See* article 26(4)(a)(ii) Netherlands-United States DTC; similar article 30(4)(b) France-United States DTC.

[190]*See* article 26(8)(i) Netherlands-United States DTC; *see also* the similar provisions in article 22(4)(c)(i) Denmark-United States DTC; article 30(6)(d) France-United States DTC; article 23(8)(e) Ireland-United States DTC; article 24(4)(d)(i) Luxembourg-United States DTC. The definition of a EC resident in article 30(6)(d) France-United States DTC technically does not apply to the derivative benefits clause because the definition limits its applicability to the term "as used in" article 30(1), as opposed to article 30(4); however, it is clear that the term should have the same meaning within the whole article; *see* for this interpretation Treasury Department Technical Explanation of the France-United States DTC (article 30) ("for purposes of subparagraph 1(c)(iii) and elsewhere in this Article"), and Schinabeck, M.J., "The Limitation on Benefits Article of the U.S.-France Tax Treaty," 22 *Tax Mgm't Int'l J.* 26 (36) (1996).

[191]A person will meet the requirement if that person would satisfy the provisions of article 4 Netherlands-United States DTC if that article were applicable to the state of residence of the person. Therefore, that person must be liable for tax in that state by reason of his domicile, residence, and so forth, as provided in article 4 Netherlands-United States DTC.

[192]A person would meet the second requirement if that person were entitled to the benefits of the Netherlands-United States DTC under article 26(1) and if the third state were the Netherlands. A company resident in a third state would be required to qualify under article 26(1)(c), that is, the direct and indirect stock exchange test, or article 26(1)(d), the ownership and base erosion test, to satisfy the requirement. A company that could only qualify under other paragraphs of article 26, such as the substantial business presence test of article 26(2) or the headquarters company rule of article 26(3), would not satisfy the requirement; *see, e.g.,* Treasury Department Technical Explanation of the U.S-Netherlands DTC (article 26(8)(i)).

person's state of residence and the United States.[193] Also, the Netherlands-United States DTC requires that the member state in which that person is resident has effective comprehensive DTCs with both the United States and the Netherlands.[194] Unlike the Netherlands-United States DTC, other treaties refer to residents of NAFTA[195] or EEA[196] countries, state a higher percentage of ownership requirement,[197] do not require a certain percentage of ownership by residents of the contracting states,[198] limit the number of shareholders,[199] or require only that the source country, not both treaty partners, has a comprehensive DTC with the third country.[200]

Regarding dividends, branch taxes, interest, and royalties, derivative benefits clauses usually provide that shares will only be considered to be held by EU residents if the shareholders are residents of EU member states that have a comprehensive DTC with the United States, and if the particular payment in respect of which treaty benefits are claimed would be subject to a rate of tax under such comprehensive DTC that is equal to or less than the rate imposed on such payment under the DTC in question.[201] Put in other

[193]A person will be considered to be otherwise entitled to the benefits of the DTC between that person's state of residence and the U.S. (that is, the second convention) if that person is entitled to the benefits of the second convention with respect to the items of income derived from the United States under all provisions of the second convention, with the exception of the LoB provision. An exception to that rule applies, however, if the LoB clause of the Netherlands-United States DTC does not contain a provision of the "same or similar nature" as the provision in the second convention; in that case, the person also must satisfy any relevant provision relating to the LoB in the second convention. *See, e.g.,* Treasury Department Technical Explanation of the U.S.-Netherlands DTC (article 26(8)(i)); *cf.* DeCarlo, J., A.W. Granwell, and S. van Weeghel, "An Overview of the Limitation on Benefits Article of the New Netherlands-U.S. Income Tax Convention," 22 *Tax Mgm't Int'l J.* 271 (278) (1993).

[194]Although article 26(8)(h) Netherlands-United States DTC defines the term "member state of the European Communities" as the Netherlands itself and any member state with which both contracting parties have in effect a comprehensive DTC, that definition applies only if the context does not require otherwise; therefore, the question may arise whether the definition adds to the definition of the term "resident of a member state of the European Communities" as provided in article 26(8)(i). Only those residents whose country of residence has an effective DTC (article 26(8)(h)) with the United States and the Netherlands would qualify. The conclusion is drawn by Doyle, H., "Is Article 26 of the Netherlands-United States Tax Treaty Compatible With EC Law?" *ET* 1995, 14 (19), and Lier, P. and T.P. North, "The New U.S.-Netherlands Treaty," 20 *Tax Planning Int'l Rev.* 3 (7) (Feb. 1993); *cf.* Terra, B. and P. Wattel, *European Tax Law,* 3rd ed., (2001) 113; the Treasury Department Technical Explanation of the U.S.-Netherlands DTC (article 26(4)(a)), however, does not refer to article 26(8)(h) in that context. If read that way, Malta would not qualify as a "member state of the European Communities," because the United States terminated its DTC with Malta effective January 1, 1997; *see* Treasury Department News Release (RR-717, Nov. 20, 1995) — United States Terminates 1980 Income Tax Treaty With Malta, *95 TNI 230-25*; *cf.* the 1995 U.S. Notice of Termination, *96 TNI 71-38*. Because the Netherlands does have DTCs with all member states, the question of interpretation is not relevant for the purposes of the derivative benefits clause insofar as a resident of Malta would not qualify under the requirements of article 26(8)(i) because of the lack of a DTC with the United States; however, in other situations, article 26(8)(h) Netherlands-United States DTC may constitute an infringement of the EC Treaty; see Doyle, H., "Is Article 26 of the Netherlands-United States Tax Treaty Compatible With EC Law?" *ET* 1995, 14 (14 *et seq*.).

[195]Article 22(4)(a)(i) Denmark-United States DTC; article 23(5)(a)(i) Ireland-United States DTC; article 24(4)(a) Luxembourg-United States DTC; article 23(3)(a), (7)(d) United Kingdom-United States DTC.

[196]Article 22(4)(a)(i) Denmark-United States DTC; article 23(3)(a), (7)(d) United Kingdom-United States DTC.

[197]Generally 95 percent; *see* article 22(4)(a)(i) Denmark-United States DTC; article 23(5)(a)(i) Ireland-United States DTC; article 24(4)(a) Luxembourg-United States DTC; article 23(3)(a) United Kingdom-United States DTC. According to the technical explanations, the ownership percentage requirement is less than 100 percent to avoid denying benefits because there is a small nonqualified shareholder; *see, e.g.,* Treasury Department Technical Explanation of the U.S.-Luxembourg DTC (article 24(4)).

[198]Article 22(4)(a)(i) Denmark-United States DTC; article 23(5)(a)(i) Ireland-United States DTC; article 24(4)(a) Luxembourg-United States DTC; article 23(3)(a), (7)(d) United Kingdom-United States DTC.

[199]Generally seven or fewer; *see* article 22(4)(a)(i) Denmark-United States DTC; article 23(5)(a)(i) Ireland-United States DTC; article 24(4)(a) Luxembourg-United States DTC; article 23(3)(a) United Kingdom-United States DTC. The limitation on the number of shareholders is set at seven in recognition of the fact that most of the companies that would want to use that provision will be subsidiaries of EU owners, for example, in most cases there will be a single owner; *see, e.g.,* Treasury Department Technical Explanation of the U.S.-Luxembourg DTC (article 24(4)); *cf.* Berman, D.M. and J.L. Hynes, "Limitation on Benefits Clauses in U.S. Income Tax Treaties," 29 *Tax Mgm't Int'l J.* 692 (705) (2000).

[200]*See* article 24(4)(a) Luxembourg-United States DTC; *see also* article 30(6)(d) France-United States DTC; article 23(7)(d)(A) United Kingdom-United States DTC; article 22(4)(c)(i) Denmark-United States DTC; article 23(8)(e) Ireland-United States DTC.

[201]*See* article 22(4)(c)(ii) Denmark-United States DTC; article 23(5)(b) Ireland-United States DTC; article 24(4)(c) Luxembourg-United States DTC; article 26(4)(b) Netherlands-United States DTC; article 23(7)(d)(B) United Kingdom-United States DTC; *cf.,* Cohen, H.J., L.A. Pollack, and Molitor, "Analysis of the New U.S.-Luxembourg Income Tax Treaty," 25 *Tax Mgm't Int'l J.* 403 (419) (1996); *see, e.g.,* Treasury Department Technical Explanation of the U.S.-U.K. DTC (article 23(3)). In the proposed version of the LoB clause of the United Kingdom-United States DTC, derivative benefits would also have been available to "a company resident in a Member State of the European Community which is entitled under the provisions of any Directive of the European Community to receive the particular class of income for which benefits are being claimed under this Convention free of withholding tax." However, that version was amended by a protocol signed on July 19, 2002, so that it takes the same form as the LoB

(continued on next page)

words, derivative benefits with regard to dividends, branch taxes, interest, and royalties are only available if the shareholders could have obtained at least such reduced rates under a tax treaty if they received such payments directly. Thus, the tax rates to be compared are the rate of withholding tax that the source state would have imposed if a qualified resident of the other contracting state were the beneficial owner of the income and the rate of withholding tax that the source state would have imposed if the third-state resident received the income directly from the source state.[202]

For the base erosion test in derivative benefits provisions, deductible payments to residents of EU member states receive special treatment. Usually, the base erosion test is not met if a certain percentage of gross income — generally 50 percent — is used to make deductible payments to nonqualified persons. However, if those deductible payments are made to EU residents, they are either not taken into account[203] or a higher percentage rate applies.[204] Therefore, in the treaties with the Netherlands and France, the base erosion test is met if less than 70 percent of gross income is used to make deductible payments to EU residents and less than 30 percent is used to make payments to other nonqualified persons.[205] In the treaties with Luxembourg, the United Kingdom, Denmark, and Ireland, the base erosion test is met even if the whole gross income is used to make payments provided at least 50 percent went to qualified EU residents.[206]

3. Derivative Benefits: Consequences for an Infringement of the EC Treaty

However, the derivative benefits clauses found in the DTCs between the United States and Denmark, France, Ireland, Luxembourg, the Netherlands, and the United Kingdom do not go far enough to comprehensively address the problem of discrimination.[207] If the ownership clause in an LoB article is discriminatory and prohibited, the problem is mitigated, but not solved, by reducing the scope of the discrimination through the derivative benefits concept: "If the 'happy few' become many, there will still be unhappy ones to whom the courts are open."[208]

This point can be clarified by a closer look at the way the LoB clause in the United Kingdom-United States DTC works. Assume, for example, that a U.S. corporation (USCo) is a wholly owned subsidiary of a U.K. corporation (UKCo), which itself is wholly owned by a publicly traded French corporation (FCo). To qualify UKCo for derivative benefits with respect to dividends, interest, or royalties, the French corporation must, *inter alia*, be entitled to a rate of withholding tax under the France-United States DTC that is at least as low as the withholding tax rate that would apply under the United Kingdom-United States DTC to that income. Assuming UKCo satisfies the requirements of article 10 United Kingdom-United States DTC, UKCo would be eligible for a zero rate of withholding tax on dividends, as opposed to the 30 percent withholding tax under U.S. domestic tax law. However, the dividend withholding rate in the treaty between the United States and France is 5 percent;[209] therefore, if FCo received the dividend directly from USCo, FCo would be subject to a 5 percent rate of withholding tax on the dividend. Because FCo would not be entitled to a rate of withholding tax under the France-United States DTC that is at least as low as the rate of zero percent that would apply under the United Kingdom-United States DTC to that income, FCo will not be considered as an

Footnote 201 continued

clause in the treaties with Denmark, Ireland, and Luxembourg; *see, e.g.,* Clark, B., "Limitation on Benefits: Changing Forms in the U.S.-U.K. Tax Treaty," *ET* 2003, 97 (98 et seq.). Finally, in the treaty between the United States and France, no such requirement exists; therefore, the availability of derivative benefits does not depend on the withholding tax rates in the treaty between the United States and the third country.

[202]*See, e.g.,* Treasury Department Technical Explanation of the U.S.-U.K. DTC (article 23(3)); Treasury Department Technical Explanation of the U.S.-Denmark DTC (article 22(4)); Treasury Department Technical Explanation of the U.S.-Ireland DTC (article 23(5)); *cf.* Bennett, M.C. et al., "Commentary to the U.S.-Netherlands Income Tax Convention" (1995) article 26-121; Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (198 *et seq*.).

[203]*See* article 22(4)(a)(ii) Denmark-United States DTC; article 23(5)(a)(ii) Ireland-United States DTC; article 24(4)(c) Luxembourg-United States DTC; article 23(3)(b) United Kingdom-United States DTC; *cf.* Treasury Department Technical Explanation of the U.S.-U.K. DTC (article 23(3)); Treasury Department Technical Explanation of the U.S.-Denmark DTC (article 22(4)); Treasury Department Technical Explanation of the U.S.-Ireland DTC (article 23(5)).

[204]Article 30(1)(d)(ii) France-United States DTC (70 percent); article 26(5)(a)(ii) Netherlands-United States DTC (70 percent).

[205]*See, e.g.,* Schinabeck, M.J., "The Limitation on Benefits Article of the U.S.-France Tax Treaty," *22 Tax Mgm't Int'l J.* 26 (32 *et seq*.) (1996); Delattre, O., "France-United States: New Tax Treaty," *BIFD* 1995, 65 (69); Lier, P. and T.P. North, "The New U.S.-Netherlands Treaty," *20 Tax Planning Int'l Rev.* 3 (7) (February 1993).

[206]*See, e.g.,* Cohen, H.J., L.A. Pollack, and R. Molitor, "Analysis of the New U.S.-Luxembourg Income Tax Treaty," 25 *Tax Mgm't Int'l J.* 403 (418) (1996); Berman, D.M. and J.L. Hynes, "Limitation on Benefits Clauses in U.S. Income Tax Treaties," 29 *Tax Mgm't Int'l J.* 692 (706) (2000); Connors, P.J. and P. White, "New United States-United Kingdom Income Tax Treaty," *DFI* 2003, 215 (217); Clark, B., "Limitation on Benefits: Changing Forms in the U.S.-U.K. Tax Treaty," *ET* 2003, 97 (97).

[207]*See, e.g.,* Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (200).

[208]Malherbe, J. and O. Delattre, "Compatibility of Limitation on Benefits Provisions with EC Law," *ET* 1996, 12 (20).

[209]Article 10(2)(a) France-United States DTC.

equivalent beneficiary with respect to dividends. In that case, UKCo would not qualify for derivative benefits and the dividends will be subject to 30 percent withholding tax.[210]

In the above case, the derivative benefits concept has no positive effect on resident corporations owned by residents of other EU member states. Putting that example in the bigger picture and taking into account that the United Kingdom-United States DTC is the only treaty concluded by the United States with an EU member state that provides for a zero-rate on dividends, the derivative benefits clause effectively excludes other EU residents from being equivalent beneficiaries.[211] Therefore, derivative benefits with respect to U.S. dividends will never be available for UKCo if it is more than 50 percent owned by other EU residents.[212] That result is also mentioned by the U.S. Joint Committee on Taxation, which said, "Unless and until the United States adopts a zero-rate provision in a treaty with a given European Community member state, companies resident in such state will not be treated as equivalent beneficiaries for purposes of claiming the zero rate under the proposed treaty."[213] The goal is to avoid European companies placing the stock of their U.S. subsidiaries into U.K. holding companies to enjoy the zero rate, both under the United Kingdom-United States DTC for the dividend flow to the United Kingdom, as well as under the EU parent-subsidiary directive[214] for the dividend flow into any other country of the EU.

E. Is the Infringement Carved Out by a Competent Authority Procedure?

1. Subjective Clauses: Competent Authority Relief in LoB Articles

Another issue is whether discretionary relief in a competent authority procedure may avoid an infringement of the EC Treaty. That argument, made occasionally in recent legal discussion,[215] seems appealing because nearly all LoB clauses in treaties between the United States and EU member states leave open the way for the competent authority to grant treaty benefits to residents that fail to meet the objective tests.[216] Those subjective clauses recognize that because of the increasing scope and diversity of international economic relations, there may be cases in which significant participation by third-country residents in an enterprise of a contracting state is warranted by sound business practice or long-standing business structures that do not necessarily indicate a motive to obtain unintended DTC benefits.[217] Subjective clauses usually provide that a resident of one of the contracting states that is not otherwise entitled to the benefits of the DTC may be granted benefits under the respective DTC if the competent authority of the state from which benefits are claimed so determines.[218] However, the competent authority has discretion to grant all benefits of the DTC, or only certain benefits. It may also set time limits on the duration of any relief granted.[219] Another provision in some treaties is that if the competent authority of the source state determines that it will not grant discretionary relief, that state is required to consult with the competent authority of the other state before denying the DTC benefits that have been requested by the taxpayer.[220]

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[210]*See, e.g.*, Treasury Department Technical Explanation of the U.S.-U.K. DTC (article 23(3)).

[211]However, under certain circumstances, a zero rate on dividends will also be available under the amended article 10(3) Netherlands-United States DTC; the respective protocol was signed on March 8, 2004, but is not in force yet.

[212]*See also* Sepho, D., "Does the U.K.-U.S. Tax Treaty Conflict With the EC's Freedom of Establishment Principle?" *Tax Notes Int'l,* Oct. 20, 2003, p. 279; Weiner, J.M., "EU Prepares for Corporate Tax Reform at Rome Conference," *Tax Notes Int'l*, Dec. 8, 2003, p. 913.

[213]Joint Committee on Taxation Explanation of the Proposed Income Tax Treaty Between the United States and the United Kingdom (JCS-4-03, Mar. 3, 2003), *2003 WTD 42-2*.

[214]Council Directive 90/435/EEC of July 23, 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states, OJ L 225, 6 (20. 8. 1990).

[215]*See* Troup, E., "Of Limited Benefits: Article 26 of the New U.S./Netherlands Double Tax Treaty Considered," *BTR* 1993, 97 (104); Martín-Jiménez, A. J., "EC Law and Clauses on 'Limitation of Benefits' in Treaties with the U.S. after Maastricht and the U.S.-Netherlands Tax Treaty," *EC Tax Rev*. 1995, 78 (83 *et seq*.); *cf*. Bennett, M.C. et. al., "A Commentary to the United States-Netherlands Tax Convention," *Intertax* 1993, 165 (197); Bennett, M.C. et al., "Commentary to the U.S.-Netherlands Income Tax Convention" (1995) article 26-61 *et seq*.

[216]*See* Appendix II for an overview of the LoB clauses in treaties between the U.S. and EU member states.

[217]*See, e.g.,* Treasury Department Technical Explanation of the United States Model Income Tax Convention of September 20, 1996*, 96 TNI 186-17*; *cf.* Van Herksen, M., "Limitation on Benefits and the Competent Authority Determination," *BIFD* 1996, 19 (24 *et seq*.).

[218]For procedural aspects from a U.S. perspective, *see* Rev. Proc. 2002-52, 2002-2 C.B. 242; *cf.* Van Herksen, M., "Limitation on Benefits and the Competent Authority Determination," *BIFD* 1996, 19 (27).

[219]*See* Treasury Department Technical Explanation of the United States Model Income Tax Convention of September 20, 1996, *96 TNI 186-17*; *see also, e.g.,* Treasury Department Technical Explanation of the U.S.-U.K. DTC (article 23(6)); Treasury Department Technical Explanation of the U.S.-Denmark DTC (article 22(7)).

[220]*See* article 16(1)(d)(i) Austria-United States DTC; article 30(7) France-United States DTC; article 23(6) Ireland- United States DTC; article 26(7) Netherlands-United States DTC; article 23(6) United Kingdom-United States DTC; *cf., e.g.,* Bennett, M.C. et. al., "A Commentary to the United States-Netherlands Tax Convention," *Intertax* 1993, 165 (195).

Some discretionary relief provisions provide explicit guidelines to consider when making the determination of whether the establishment, acquisition, or maintenance of a corporate taxpayer or the conduct of its operations has or had as one of its principal purposes the receipt of benefits under the respective DTC.[221] The provisions partly implement the recommendation of the OECD to include a bona fide clause in LoB provisions to provide a means for taxpayers to qualify for treaty benefits for their legitimate business arrangements even if they do not meet the objective tests.[222] Unlike in the OECD recommendation, subjective clauses in the LoB articles are not self-executing and depend mainly on the rulings practice of the involved competent authorities.[223]

2. The EU Factor

Because of alleged conflicts with EC law, however, in some treaty negotiations the requirements of EC law were explicitly considered to be deciding factors for the determination to be made by the U.S. competent authority when applying the subjective clause. That has been the case with Austria,[224] Germany,[225] the Netherlands,[226] and the United Kingdom.[227] However, that consideration was only part of an informal Memorandum of Understanding to the treaty between the United States and Finland.[228] The addition of EC law as an explicit factor in interpreting subjective clauses of U.S. DTCs began with the consideration of a situation in which a resident corporation was acquired or merged into a company resident in another member state and therefore would no longer qualify under the respective DTC. In that case, it was argued that the LoB provision would have been a barrier to the free movement of capital or the freedom of establishment, and therefore that the member state had violated its obligations under the EC Treaty.[229]

To avoid infringing on EC fundamental freedoms, in the Memorandum of Understanding (MOU) to the treaty between the United States and the Netherlands, the contracting states acknowledged an EU factor as a guideline for the subjective clause: "The legal requirements or the facilitation of the free flow of capital and persons within the European Communities, together with the differing internal income tax systems, tax incentive regimes, and existing tax treaty policies among member states of the European Communities, will be considered."[230] A similar guideline is contained in the Diplomatic Note to the treaty between the United States and the United Kingdom: "The competent authorities will consider the obligations imposed upon the United Kingdom by its membership of the European Community and by its being a party to the European Economic Area Agreement, and on the United States by its being a party to the North American Free Trade Agreement. In particular, they will have regard to any legal requirements for the facilitation of the free movement of capital and persons, the differing internal tax systems, tax incentive regimes, and existing tax treaty policies among member states of the European Community or European Economic Area states, or, as the case may be, parties to the North American Free Trade Agreement."[231]

The above-mentioned documents consider changes in circumstances that would prevent a company from qualifying for treaty benefits under the respective LoB

[221]*See* article 30(7)(a) France-United States DTC; article 23(6) Ireland-United States DTC; article 26(7) Netherlands-United States DTC; article 17(3i) Portugal-United States DTC; article 17(2) Spain-United States DTC; article 23(6) United Kingdom-United States DTC; for a list of factors, *see* article XIX *et seq*. of the memorandum of understanding to the Netherlands-United States DTC; article 16(2) of the memorandum of understanding to the Austria-United States DTC; *cf., e.g.,* Bennett, M.C., et. al., "A Commentary to the United States-Netherlands Tax Convention," *Intertax* 1993, 165 (196 *et seq*.); Bennett, M.C., et al., "Commentary to the U.S.-Netherlands Income Tax Convention" (1995) article 26-52 *et seq*. No such explicit guidelines are given, e.g., in the Luxembourg-United States DTC.

[222]OECD, Commentaries to the Model Tax Convention on Income and on Capital 2003, article 1 para. 19.

[223]*See* Schinabeck, M.J., "The Limitation on Benefits Article of the U.S.-France Tax Treaty," 22 *Tax Mgm't Int'l J*. 26 (38 *et seq*.) (1996).

[224]Article 16(2) of the memorandum of understanding to the Austria-United States DTC.

[225]Memorandum of understanding to the Germany-United States DTC — Understandings Regarding the Scope of the Limitation in Benefits Article (B.); Treasury Department Technical Explanation of the U.S.-Germany DTC (article 28); *cf.* Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus*. 165 (193 *et seq*.) (1997).

[226]*See* article XIX of the memorandum of understanding to the Netherlands-United States DTC; *cf.* Van Herksen, M., "Limitation on Benefits and the Competent Authority Determination," *BIFD* 1996, 19 (26 *et seq*.).

[227]Diplomatic Note to the U.S.-U.K. Treaty with reference to article 23(6)); *cf.* Treasury Department Technical Explanation of the U.S.-U.K. DTC (article 23(6)); Berner, R. and G. May, "The New U.K.-U.S. Income Tax Treaty Revisited," 32 *Tax Mgm't Int'l J.* 395 (395 *et seq*.) (2003).

[228]*See* Treasury Department Technical Explanation of the U.S.-Finland DTC (article 16).

[229]*See* Bennett, M.C., et. al., "A Commentary to the United States-Netherlands Tax Convention," *Intertax* 1993, 165 (196 *et seq*.).

[230]Article XIX of the memorandum of understanding to the Netherlands-United States DTC. A more elaborate consideration of the EU factor is contained in article XXVIII(c) of the memorandum of understanding to the protocol to the Netherlands-United States DTC, which was signed on March 8, 2004, but is not in force yet.

[231]Diplomatic Note to the United Kingdom-United States treaty with reference to article 23(6)); *cf.* Treasury Department Technical Explanation of the U.S.-U.K. DTC (article 23(6)).

clause, such as a change in the state of residence of a major shareholder of a company, the sale of part of the stock of a company to a person resident in another qualified state, or an expansion of a company's activities in another qualified state, all under ordinary business conditions.[232] With the subjective clause, those changes in circumstances will be considered by the competent authority to determine whether a company will remain qualified for treaty benefits with respect to income received from U.S. sources. In other words, the EU factor may help present a sympathetic case to the competent authority, but in and of itself, the EU factor will not be sufficient to qualify for treaty benefits.[233]

The same is true for more general considerations of the EU factor in the MOUs between the United States and Germany and Austria, respectively. The Memorandum of Understanding to the treaty between the United States and Germany states that the discretionary authority granted to the competent authorities in the subjective clause "is particularly important in view of, and should be exercised with particular cognizance of, the developments in, and objectives of, international economic integration, such as that between the member countries of the European Communities and between the United States and Canada."[234] Similar language is included in an informal Memorandum of Understanding to the treaty between the United States and Finland.[235] A more elaborate guideline is found in the Memorandum of Understanding to the treaty between the United States and Austria. Under that clause, it is understood that Austria's EU membership will be a factor in the determination under the subjective clause "of eligibility for benefits of Austrian companies with significant non-Austrian, but EU Member, ownership, or with significant business activities carried on in EU Member States as well as in Austria." In addition to reflecting Austria's EU membership in competent authority determinations, "it is also understood that the United States and Austria will discuss whether a need exists to amend Article 16 to reflect the closer relationship between Austria and its EU partners. If such amendments appear desirable, a Protocol to this Convention will be promptly negotiated to reflect this understanding."[236]

3. Competent Authority Relief: Consequences for the Inquiry of an Infringement of the EC Treaty

It has been argued that criticism based on a possible infringement of the EC Treaty will be difficult to uphold for those DTCs that contain the EU factor as a guideline for the competent authority determination, since the treaty — by way of the subjective clause — considers the obligations of member states derived from their EU membership.[237] However, the subjective clauses are not self-executing, and the decision whether to grant relief in the light of the EU factor is entirely within the discretion of the U.S. competent authority. In that regard, the ECJ has already held in the early *Patrick* case[238] that a member state cannot make the exercise of the right to free establishment by a national of another member state conditional on an exceptional authorization if such national of another member state fulfils the conditions laid down by the country of establishment for its own nationals. The ECJ has also held that the incompatibility between national law provisions and treaty provisions, even those directly applicable, can be eliminated only by binding domestic provisions that have the same legal force as those that require amendment. Before the case law of the ECJ, the chance of discretionary administrative relief is not sufficient to carve out the discriminatory features of LoB clauses, even if consideration of EU obligations is explicitly a factor.[239]

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[232]*See* article XIX of the memorandum of understanding to the Netherlands-United States DTC; diplomatic note to the United Kingdom-United States treaty with reference to article 23(6)); Treasury Department Technical Explanation of the U.S.-U.K. DTC (article 23(6)); *cf.* DeCarlo, J., A.W. Granwell, and S. van Weeghel, "An Overview of the Limitation on Benefits Article of the New Netherlands-U.S. Income Tax Convention," 22 *Tax Mgm't Int'l* J. 271 (279) (1993)

[233]*See also* Van Herksen, M., "Limitation on Benefits and the Competent Authority Determination," *BIFD* 1996, 19 (26); *cf., e.g.,* diplomatic note to the United States-United Kingdom treaty with reference to article 23(6)), and Treasury Department Technical Explanation of the U.S.-U.K. DTC (article 23(6)).

[234]Memorandum of Understanding to the Germany-United States DTC — Understandings Regarding the Scope of the Limitation in Benefits Article (B.)

[235]Treasury Department Technical Explanation of the U.S.-Finland DTC (article 16).

[236]Article 16(2) of the Memorandum of Understanding to the Austria-United States DTC; *see also* Treasury Department Technical Explanation of the U.S.-Austria DTC (article 16(2)); *cf.* Schuch, J. and G. Toifl, "Austria: Highlights of the New Tax Treaty With the United States," *ET* 1998, 20 (30).

[237]*See, e.g.,* Bennett, M.C., et. al., "A Commentary to the United States-Netherlands Tax Convention," *Intertax* 1993, 165 (197); Bennett, M.C. et al., "Commentary to the U.S.-Netherlands Income Tax Convention" (1995) article 26-62.

[238]ECJ 28. 6. 1977, 11/77, ECR 1977, 1199, *Patrick* — para. 15.

[239]*See also* Eilers, S. and M. Watkins-Brügmann, "Article 28 of the German-U.S. Double Taxation Treaty of 1989: An Appropriate Solution of the Treaty Shopping Problem?" 20 *Tax Planning Int'l Rev*. 15 (20) (Sept. 1993); Hinnekens, L., "Compatibility of Bilateral Tax Treaties With European Community Law — Application of the Rules," *EC Tax Rev*. 1995, 202 (228); Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus*. 165 (193 *et seq*.) (1997); Craig, A., "Open Your Eyes: What the 'Open Skies' Cases Could Mean for the U.S. Tax Treaties With the EU Member States," *BIFD* 2003, 63 (73); *cf.* van Raad, K., "The Impact of the EC Treaty's Fundamental Freedoms Provisions on EU Member States' Taxation in Border-Crossing Situations — Current State of Affairs," *EC Tax Rev*. 1994, 190 (200).

Therefore, administrative practices, which by their nature are mutable at will by the authorities and generally not given appropriate publicity, cannot be regarded as properly fulfilling a member state's obligations under the EC Treaty, because they maintain, for the persons concerned, a state of uncertainty regarding the extent of their rights as guaranteed by the treaty.[240] Under ECJ case law, it is necessary to protect subsidiaries of EU companies with rules of similar legal binding force as those that benefit comparable national taxpayers.[241] It does not suffice to meet the requirements of the EC Treaty for other EU residents "to have to rely on equitable measures adopted by the tax administration on a case-by-case basis," since the EC Treaty requires "equal treatment at [the] procedural level for nonresident Community nationals and resident nationals."[242] Moreover, the need to claim *a posteriori* the application of such a clause, instead of the automatic application of the tax benefits available to the nationals of the member state, is a clear example of discrimination on its own.

This said, another approach would be to broaden the type of persons automatically entitled to treaty benefits to include for purposes of the ownership clause all EU residents, but to grant the competent authorities the discretionary power to deny benefits on a case-by-case basis, based on the inquiry whether the purported economic links exist and whether tax avoidance actually takes place.[243] If that approach were combined with appropriate safe harbors, it would be possible to create a balance between the administrative interests of the revenue services. Also, taxpayers' interests would not suffer due to lack of certainty in tax-planning stages.

F. Justification Under the Rule of Reason?

Once it is deterimined that an LoB is a covert discrimination, that discrimination can be justified only if that provision pursues a legitimate aim compatible with the EC Treaty and is justified by pressing reasons of public interest.[244] Moreover, the provision would have to ensure achievement of the aim in question and not go beyond what was necessary for that purpose.[245] Based on the overview above,[246] the discrimination caused by current LoB provisions can hardly be justified in light of the ECJ's case law. It is generally agreed that neither the coherence of the tax system,[247] the lack of harmonization of direct taxation,[248] the principles of international tax law,[249] nor administrative difficulties[250] may justify the discrimination by those clauses. However, the prevention of treaty shopping through LoB clauses can be valid grounds of justification. As mentioned, the LoB provisions address the problem of treaty shopping by ensuring that only those persons intended to benefit

[240]*See* ECJ 15. 10. 1986, 168/85, ECR 1986, 2945, *Commission / Italy* — para. 11; ECJ 11. 6. 1991, C-307/89, ECR 1991, I-2903, *Commission / France* — para. 13; ECJ 25. 7. 1991, C-58/90, ECR 1991, I-4193, *Commission / Italy* — para. 12 *et seq*.; ECJ 17. 11. 1992, C-236/91, ECR 1992, I-5933, *Commission / Ireland* — para. 6; ECJ 26. 1. 1994, C-381/92, ECR 1994, I-215, *Commission / Ireland* — para. 7; ECJ 24. 3. 1994, C-80/92, ECR 1994, I-1019 *Commission / Belgium* — para. 20; ECJ 26. 10. 1995, C-151/94, ECR 1995, I-3685, *Commission / Luxembourg* — para. 18; ECJ 29. 10. 1998, C-185/96, ECR 1998, I-6601, *Commission / Greece* — para. 32; ECJ 18. 1. 2001, C-162/99, ECR 2001, I-541, *Commission / Italy* — para. 33; ECJ 13. 7. 2000, C-160/99, ECR 2000, I-6137, *Commission / France* — para. 23.

[241]*See* Martín-Jiménez, A.J., F.A. García Prats, and J.M. Calderón Carrero, "Triangular Cases, Tax Treaties and EC Law: The *Saint-Gobain* Decision of the ECJ," *BIFD* 2001, 241 (251).

[242]ECJ 14. 2. 1995, C-279/93, ECR 1995, I-225, *Schumacker* — para. 57 *et seq*.

[243]*See* for these criteria *infra* III.F.

[244]*See, e.g.,* ECJ 28. 1. 1992, C-204/90, ECR 1992, I-249, *Bachmann* — para. 21 *et seq*,; ECJ 28. 1. 1992, C-300/90, ECR 1992, I-305, *Commission / Belgium* — para. 14 et seq.; ECJ 27. 6. 1996, C-107/94, ECR 1996, I-3089, *Asscher* — para. 49 *et seq*.; ECJ 3. 10. 2002, C-136/00, ECR 2002, I-8147, *Danner* — para. 33 *et seq*. and para. 44 *et seq*.

[245]ECJ 15. 5. 1997, C-250/95, ECR 1997, I-2471, *Futura Participations* — para. 26; ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 49.

[246]*Supra* III.A.3.

[247]*See* Troup, E., "Of Limited Benefits: Article 26 of the New U.S./Netherlands Double Tax Treaty Considered," *BTR* 1993, 97 (103); Doyle, H., "Is Article 26 of the Netherlands-United States Tax Treaty Compatible With EC Law?" *ET* 1995, 14 (21); Offermanns, R., "Tax Treaties in Conflict With the EC Treaty: The Incompatibility of Anti-Abuse Provisions and EC Law," *EC Tax Rev*. 1995, 97 (97); Lang, M., "Die Bindung der Doppelbesteuerungsabkommen an die Grundfreiheiten des EU-Rechts," in Gassner, W., M. Lang, and E. Lechner (Eds.), *Doppelbesteuerungsabkommen und EU-Recht* (1996) 25 (38 *et seq*.); Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus*. 165 (197 *et seq*.) (1997); *but see* Van Unnik, D. and M. Boudesteijn, "The New U.S.-Dutch Treaty and the Treaty of Rome," *EC Tax Rev*. 1993, 106 (112 *et seq*.).

[248]*See* Doyle, H., "Is Article 26 of the Netherlands-United States Tax Treaty Compatible With EC Law?" *ET* 1995, 14 (20 et seq.); Offermanns, R., "Tax Treaties in Conflict With the EC Treaty: The Incompatibility of Anti-Abuse Provisions and EC Law," *EC Tax Rev*. 1995, 97 (97).

[249]*See, e.g.,* Lang, M., "Die Bindung der Doppelbesteuerungsabkommen an die Grundfreiheiten des EU-Rechts," in Gassner, W., M. Lang, and E. Lechner (Eds.), *Doppelbesteuerungsabkommen und EU-Recht* (1996) 25 (34 *et seq*.); *cf.* Essers, P. and R.H.M.J. Offermanns, "Tax Treaties in Conflict With the EC Treaty: The Incompatibility of Anti-Abuse Provisions and EC Law," 22 *Int'l Tax J*. 68 (69 *et seq*.) (1996); Craig, A., "Open Your Eyes: What the 'Open Skies' Cases Could Mean for the U.S. Tax Treaties With the EU Member States," *BIFD* 2003, 63 (72).

[250]*See* Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus*. 165 (199 *et seq*.) (1997).

from the respective DTC will do so; thus, treaty benefits which would untimately favor residents of third states that do not have substantial business in, or business nexus with, the contracting state are denied.[251] It has been argued that the goal of LoB provisions — the prevention of treaty shopping — may justify a discriminatory effect. That observation is consistent with ECJ case law, under which the prevention of tax evasion or tax avoidance constitutes, *in abstracto*, an overriding requirement of general interest capable of justifying a restriction on the exercise of fundamental freedoms guaranteed by the EC Treaty.[252] However, as mentioned before, that *in abstracto* recognition has *in concreto* never been able to save restrictive national measures brought before the ECJ.[253]

To justify the use of LoB clauses for the purpose of preventing treaty shoppings, several factors must be considered. First, the prevention of treaty shopping is in the interest of the source country. Because existing ECJ case law addresses avoidance of tax imposed by the member state accused of discrimination,[254] it may be asked whether prevention of the avoidance of taxes imposed by a third country (the United States) constitutes grounds for justification for a member state's discrimination. It could be argued that the underlying principle of all bilateral tax treaties is the principle of reciprocity. That principle would be impeded when a third-country resident derives benefits from a treaty intended to serve only the interests of residents of the contracting states. A deficiency in reciprocity results when a third-country resident derives benefits through the interposition of a treaty-protected entity, while the source country's residents are not necessarily able to obtain similar benefits from the third country.[255] However, both parties to a tax treaty make concessions on their source-based tax; the source country fully or partially relinquishes its right to tax domestic-source income earned by residents of the other party and reciprocally receives the same concessions for its residents. The assumption is that tax treaties have neutral revenue effects, which means that a provision resulting in loss of revenue will be offset by other provisions increasing revenue.[256] Because of that, a member state may argue that the prevention of treaty shopping with regard to U.S. withholding taxes, in a macro-perspective, has a reciprocal effect and therefore protects its own tax base or at least the funding of the concessions made to the United States, for which the treaty shopper's country has not made any correlative contribution.[257] This reciprocity argument is most likely invalid, because the ECJ has held that reduction in tax revenue cannot justify unequal treatment which is, in principle, incompatible with article 43 EC.[258] Furthermore, the ECJ has repeatedly rejected arguments on the basis of the balance of DTCs.[259]

Even assuming that the reciprocity argument is valid and that a member state may, *in abstracto*, rely on indirectly the treaty-shopping argument, measures to prevent tax avoidance must, *in concreto*, ensure the achievement of the goal in question and not go beyond what was necessary for that purpose.[260] As the ECJ

[251]Against this background, LoB provisions and the antiabuse provisions of domestic law complement each other, as LoB provisions generally determine whether an entity has sufficient nexus to the contracting state to be treated as a resident for treaty purposes, while domestic antiabuse provisions (for example, business purpose, substance-over-form, step transaction, or conduit principles) determine whether a particular transaction should be recast in accordance with the substance of the transaction. *See* Treasury Department Technical Explanation of the United States Model Income Tax Convention of September 20, 1996 (article 22), *96 TNI 186-17*; *cf., e.g.,* Treasury Department Technical Explanation of the U.S.-Austria DTC (article 16).

[252]ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 26; ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 57; ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 61; ECJ 12. 12. 2002, C-324/00, ECR 2002, I-11779, *Lankhorst-Hohorst* — para. 37; *cf., e.g.,* Terra, B. and P. Wattel, *European Tax Law,* 3rd ed., (2001) 77 *et seq*.

[253]*See* Terra, B. and P. Wattel, *European Tax Law,* 3rd ed., (2001) 77.

[254]*See, e.g.,* ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 26.

[255]*See* Haug, S.M., "The United States Policy of Stringent Anti-Treaty-Shopping Provisions: A Comparative Analysis," 29 *Vand. J. Transnat'l L.* 191 (218) (1996).

[256]*See* Rosenbloom, H.D., "Tax Treaty Abuse: Policies and Issues," 15 *Law & Pol'y Int'l Bus*. 763 (774) (1983); Haug, S.M., "The United States Policy of Stringent Anti-Treaty-Shopping Provisions: A Comparative Analysis," 29 *Vand. J. Transnat'l L*. 191 (218) (1996).

[257]*See* for a general discussion, *e.g.,* Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (196).

[258]ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 28; ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 59, ECJ 21. 9. 1999, C-307/97, ECR 1999, I-6161, *Saint-Gobain* — para. 51; ECJ 6. 6. 2000, C-35/98, ECR 2000, I-4071, *Verkooijen* — para. 48; ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 50.

[259]*See, e.g.,* Lang, M., "Die Bindung der Doppelbesteuerungsabkommen an die Grundfreiheiten des EU-Rechts," in W. Gassner, M. Lang, and E. Lechner (Eds.), *Doppelbesteuerungsabkommen und EU-Recht* (1996) 25 (32 *et seq*.); Schuch, J., "'Most Favoured Nation Clause' in Tax Treaty Law," *EC Tax Rev*. 1996, 161 (163 *et seq*.). For example, in the famous *avoir fiscal* case, the ECJ stated that the rights conferred by article 43 EC are unconditional "and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State" (ECJ 28. 1. 1986, 270/83, ECR 1986, 273, *Commission/France* (*avoir fiscal*) — para. 26).

[260]ECJ 15. 5. 1997, C-250/95, ECR 1997, I-2471, *Futura Participations* — para. 26; ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 49.

stated in its settled case law, a measure must "have the specific purpose of preventing wholly artificial arrangements."[261] The guidelines for approaching this standard in an intra-EU context are clear: The ECJ has held that tax avoidance cannot be inferred generally from the fact that a parent company is established in another member state.[262] Therefore, in an intra-EU context, a measure that applies to any situation in which the parent company has its seat, for whatever reason, outside the member state in which its subsidiary is resident, cannot automatically justify a restriction of a fundamental freedom.[263] However, that argument considers that such a company will in any event be subject to the tax legislation of the member state in which it is established.[264]

It is not clear whether that case law to "tax jurisdiction shopping" within the EU similarly applies to the avoidance of withholding tax in the third country by treaty shopping and thus to LoB clauses. Because a member state must make the argument to justify a discriminatory measure, that member state will have to show that a LoB provision does not go beyond what was necessary for the purpose of preventing treaty shopping. In the context of developed ECJ case law, such an attempt is doomed to fail. The Court stated in the *Leur-Bloem* case[265] and in the *Commission / Belgium* case[266] that "a general presumption of tax evasion or tax fraud cannot justify a fiscal measure" in which the "contested measure consists in an outright prohibition on the exercise of a fundamental freedom." Applying that case law to LoB clauses, it is clear that the objective tests of those provisions do not provide a flexible method for assessing purported economic links and therefore do not pursue a case-by-case inquiry on whether tax avoidance or tax evasion has taken place.[267] Moreover, the very goal of such objective tests is to avoid making a subjective determination of the taxpayer's intent.[268] LoB clauses therefore most likely represent a disproportionate antiabuse measure, as they exceed the extent that is strictly required for the purpose of countering treaty abuse to the detriment of fundamental freedoms.[269]

Finally, another argument must be considered. The argument is that since the United States could achieve the same result unilaterally, the member state should not be blamed for it.[270] However, pursuant to the open skies decisions, that argument has lost much of its validity. By concluding that some member states infringed article 43 EC, the open skies decisions go beyond the argument that the respective member states should not have concluded agreements with the United States in which the nationality clause was contrary to the EC Treaty. Furthermore, the ECJ rejected the member states' argument that they could not force the United States as a sovereign state to grant services to companies not owned or controlled by nationals of the respective member state. The ECJ implicitly recognized that the member states had an obligation to negotiate the agreements to avoid the insertion of nationality clauses.[271] Thus, each member state bears an obligation to negotiate its treaties in compliance with EC law without regard to a possible treaty override under the treaty partner's domestic law.

IV. Legal Effects of Limitation on Benefits Clauses Contrary to the EC Treaty: Renegotiation, Community Competence, State Liability, and Restitution

Like the nationality clauses in the open skies agreements, the ownership clauses in LoB provisions are contrary to the freedom of establishment under article 43 EC or to the freedom of capital movement under article 56 EC, as the case may be. Another similarity

[261]ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 26; *see also* ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 61; *see also* Terra, B. and P. Wattel, *European Tax Law*, 3rd ed., (2001) 83.

[262]ECJ 21. 11. 2002, C-436/00, ECR 2002, I-10829, *X and Y* — para. 62.

[263]ECJ 12. 12. 2002, C-324/00, ECR 2002, I-11779, *Lankhorst-Hohorst* — para. 37.

[264]ECJ 16. 7. 1998, C-264/96, ECR 1998, I-4695, *ICI* — para. 26; ECJ 12. 12. 2002, C-324/00, ECR 2002, I-11779, *Lankhorst-Hohorst* — para. 37.

[265]ECJ 17. 7. 1997, C-28/95, ECR 1997, I-4161, *Leur-Bloem* — para. 44.

[266]ECJ 26. 9. 2000, C-478/98, ECR 2000, I-7587, *Commission / Belgium* — para. 45.

[267]*See* Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus*. 165 (201 *et seq*., 206) (1997); Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (197).

[268]*See, e.g.,* Rasmussen, M. and D.D. Bernhardt, "Denmark: The 'Limitation on Benefits' Provisions in the Tax Treaty With the United States," *ET* 2001, 138 (139).

[269]*See, e.g.,* Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (197); Pistone, P., "The Impact of Community Law on Tax Treaties," (2002) 91.

[270]*See* for this argument Van Unnik, D. and M. Boudesteijn, "The New U.S.-Dutch Treaty and the Treaty of Rome," *EC Tax Rev*. 1993, 106 (114); Toifl, G., "Austria," in Essers, P., G. de Bont, and E. Kemmeren (Eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties With EC Law* (1998) 41 (83 *et seq*.).

[271]*See* Sepho, D., "Does the U.K.-U.S. Tax Treaty Conflict With the EC's Freedom of Establishment Principle?" *Tax Notes Int'l*, Oct. 20, 2003, p. 279; *see* also Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (191 *et seq*., 195).

between the nationality clauses in air transport agreements and the ownership clauses in LoB provisions is that nothing will hinder the ECJ in concluding that the direct source of that discrimination is not the possible conduct of the United States — that is, the denial of benefits under an LoB clause — but the ownership clause in the LoB provision itself, which specifically acknowledges the right of the United States to act in that way.[272] Because article 307 EC does not apply to treaties between member states and third countries concluded after the accession to the EU,[273] EC law prevails over bilateral treaties by virtue of hierarchy.[274] However, in that case, the member states are prevented not only from contracting new international commitments but also from maintaining preexisting commitments if they infringe EC law.[275]

Perhaps the only feasible way to bring the DTCs between the member states and the United States in compliance with EC law is to renegotiate and adjust the LoB clauses, which could be done with a protocol.[276] Because of the inferior negotiation power of some smaller member states, renegotiation will not be an easy task, because the United States was in the first instance unwilling to draft LoB provisions to reflect the EU membership of its treaty partners.[277] That situation therefore could give new life to the old recommendation in the Ruding Report for member states to coordinate negotiations of their tax treaties with third countries under the auspices of the Commission.[278]

That said, it may be derived from the open skies judgments that member states should be circumspect in concluding international agreements in spheres purported to be covered by a complete set of common rules adopted by the EC.[279] However, unlike for air transport, which was the subject of the open skies judgments, direct taxation in the EU is not densely covered by EC regulations. Tax sovereignty is still retained by the member states and each member state preserves its competence to enter into bilateral agreements with third countries;[280] however, the member states must exercise their powers according to EC law.[281] It should nevertheless be remembered that the ECJ's case law in the nondiscrimination area may amount to common rules that could lead to a piecemeal fettering and ousting of the member states to enter into certain arrangements, such as LoB clauses with the United States.[282] Therefore, to achieve greater consistency and compatibility among treaty provisions, the Commission may suggest that it negotiate tax treaties on behalf of all member states,[283] as it has already done in the context of the open skies agreements.[284]

[272]*See, e.g.,* ECJ 5. 11. 2002, C-475/98, ECR 2002, I-9797, *Commission/Austria* — para. 142.

[273]*See* for a discussion of article 307 EC *supra* III.C.

[274]*See, e.g.,* Pistone, P., "The Impact of Community Law on Tax Treaties" (2002) 84; *see also* ECJ 27. 2. 1962, 10/61, ECR 1961, 1, *Commission/Italy*.

[275]ECJ 5. 11. 2002, C-475/98, ECR 2002, I-9797, *Commission/Austria* — para. 49; *see* also ECJ 4. 7. 2000, C-62/98, ECR 2000, I-5171, *Commission/Portugal*; ECJ 4. 7. 2000, C-84/98, ECR 2000, I-5215, *Commission/Portugal*.

[276]*See, e.g.,* Vanistendael, F., "The Limits to the New Community Tax Order," *CML Rev*. 1994, 293 (308); *cf.* Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus*. 165 (211 *et seq*.) (1997); Clark, B., "The Limitation on Benefits Clause Under an Open Sky," *ET* 2003, 22 (26).

[277]*See, e.g.,* Troup, E., "Of Limited Benefits: Article 26 of the New U.S./Netherlands Double Tax Treaty Considered," *BTR* 1993, 97 (97 *et seq*.); DeCarlo, J., A.W. Granwell, and S. van Weeghel, "An Overview of the Limitation on Benefits Article of the New Netherlands-U.S. Income Tax Convention," 22 *Tax Mgm't Int'l J*. 271 (280) (1993).

[278]Commission of the European Communities (Ed.), Report of the Committee of Independent Experts on Company Taxation — Ruding Report (1992) 206; *cf.* Vanistendael, F., "The Limits to the New Community Tax Order," *CML Rev*. 1994, 293 (299); Kaye, T.A., "European Tax Harmonization and the Implications for U.S. Tax Policy," 19 *B. C. Int'l & Comp. L. Rev*. 109 (166) (1996).

[279]*See, e.g.,* Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (194).

[280]*See, e.g.*, Avery Jones, J.F., "Flows of Capital Between the EU and Third Countries and the Consequences of Disharmony in European International Tax Law," *EC Tax Rev*. 1998, 95 (102).

[281]*See supra* note 66; *cf.* Malherbe, J. and O. Delattre, "Compatibility of Limitation on Benefits Provisions With EC Law," *ET* 1996, 12 (13 *et seq*.).

[282]For a further discussion of these competence issues, see Terra, B. and P. Wattel, *European Tax Law*, 3rd ed., (2001) 110 *et seq*.; *cf.* Hinnekens, L., "Compatibility of Bilateral Tax Treaties with European Community Law — The Rules," *EC Tax Rev*. 1994, 146 (156 *et seq*.); Vanistendael, F., "The Limits to the New Community Tax Order," *CML Rev*. 1994, 293 (301 *et seq*.); Farmer, P., "EC Law and Direct Taxation — Some Thoughts on Recent Issues," *EC Tax J*. 1995/96, 91 (99 *et seq*.); Lang, M., "Doppelbesteuerungsabkommen und Gemeinschaftsrecht," in G.E. Breuninger, W. Müller, and E. Haarmann-Strobl (Eds.), *Steuerrecht und Europäische Integration, Festschrift Rädler* (1999) 442 *et seq*.; Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (194).

[283]For the benefits of a single U.S.-EU DTC, *see* Kaye, T.A., "European Tax Harmonization and the Implications for U.S. Tax Policy," 19 *B. C. Int'l & Comp. L. Rev*. 109 (168) (1996); *cf.* Anders, D., "The Limitation on Benefits Clause of the U.S.-German Tax Treaty and Its Compatibility With European Union Law," 18 *Nw. J. Int'l L. & Bus*. 165 (214 *et seq*.) (1997); Vanistendael, F., "Impact of European Tax Law on Tax Treaties With Third Countries," *EC Tax Rev*. 1999, 163 (166).

[284]On February 26, 2003, the Commission adopted a package of measures that would give it a general mandate to negotiate Community agreements with third countries to remove discrimination among EU airlines; *see* press release "Open Skies: Commission Sets Out Its International Air Transport Policy," 26. 2.

(continued on next page)

Keeping in mind that in the open skies judgments the ECJ placed the liability for the breach of EC law on the respective contracting member states, the question arises of what immediate remedies result for taxpayers excluded from treaty benefits because of the application of the ownership clause by the United States. Some commentators have suggested that the respective member state may be liable for damages under the *Francovich* principle of state liability.[285] In a simplified view, aside from the costs for complying with the requisite ownership structure or the reduced marketability of a subsidiary because of a nonreduction of withholding taxes, the loss from the application of the LoB clause by the United States would be the difference between the withholding tax imposed by the United States — that is, 30 percent[286] — and the reduced treaty rate that would apply for qualified residents. Under the *Francovich* principle, member states are obliged to make good such loss caused to individuals by breaches of EC law for which they can be held responsible.[287]

The prerequisites for a state liability under the *Francovich* principle are that the rule of law infringed must be intended to confer rights on individuals; the breach must be sufficiently serious; and there must be a direct causal link between the breach of the obligation resting on the state and the damage sustained by the injured parties.[288] The first condition is met if fundamental freedoms are infringed since under settled case law those freedoms confer rights on individuals.[289] Regarding the second condition, the decisive test for finding that a breach of Community law is sufficiently serious is whether the member state manifestly and gravely disregarded the limits on its discretion.[290] The factors to be considered include the clarity and precision of the rule breached, the measure of discretion left by that rule to the authorities, whether the infringement and the damage caused were intentional or involuntary, whether any error of law was excusable or inexcusable, whether the position taken by a Community institution may have contributed toward the omission, and the adoption or retention of national measures or practices contrary to Community law.[291] According to settled case law, a breach of Community law will be considered sufficiently serious if it has persisted despite a judgment finding the infringement to be established, or if a preliminary ruling or settled case law of the Court constituted an infringement.[292] With that background, the open skies decisions of the ECJ, the statements of the Commission,[293] and the written legal criticism concerning the infringement of EC law by LoB clauses, it is likely that the second condition is met.[294] For the third condition, the national tribunal, which hears the case, must determine if a direct causal link exists between the breach of the obligation borne by the member state and the damage sustained by the injured party.[295] However, such a direct causal link between the infringement of article 43 EC by a contracting member state and a pecuniary loss (that is, withholding tax paid) borne by subsidiaries of EU parent companies is likely to be recognized

Footnote 284 continued

2002, IP/03/281. In the release, the Commission considered "that the Council of the European Union should give the final go-ahead to EU-level negotiations with the United States. For its part, the US has indicated that it is open to the idea of negotiations with the Community." British Airways had proposed that the member states give a mandate to the Commission to negotiate on behalf of the community "since the Community has more power as a negotiating bloc than individual states"; *see also* Weiner, J.M., "EU Prepares for Corporate Tax Reform at Rome Conference," *Tax Notes Int'l,* Dec. 8, 2003, p. 913.

[285]*See, e.g.,* Hinnekens, L., "Compatibility of Bilateral Tax Treaties with European Community Law — Application of the Rules," *EC Tax Rev*. 1995, 202 (227 *et seq*.); Martín-Jiménez, A.J., "EC Law and Clauses on 'Limitation of Benefits' in Treaties With the U.S. After Maastricht and the U.S.-Netherlands Tax Treaty," *EC Tax Rev*. 1995, 78 (88); Essers, P. and R.H.M.J. Offermanns, "Tax Treaties in Conflict With the EC Treaty: The Incompatibility of Anti-Abuse Provisions and EC Law," 22 *Int'l Tax J.* 68 (71) (1996); Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (201); Sepho, D., "Does the U.K.-U.S. Tax Treaty Conflict With the EC's Freedom of Establishment Principle?" *Tax Notes Int'l*, Oct. 20, 2003, p. 279.

[286]IRC sections 881, 1442.

[287]ECJ 19. 11. 1991, C-6/90 and C-9/90, ECR 1991, I-5357, *Francovich* — para. 37. For a comprehensive overview over recent issues of state liability, *see, e.g.,* Tridimas, T., "Liability for Breach of Community Law: Growing Up and Mellowing Down?" *CML Rev*. 2001, 301 (301 *et seq*.).

[288]*See, e.g.,* ECJ 19. 11. 1991, C-6/90 and C-9/90, ECR 1991, I-5357, *Francovich* — para. 40 *et seq*.; ECJ 5. 3. 1996, C-46/93 and C-48/93, ECR 1996, I-1029, *Brasserie du Pêcheur* — para. 54.

[289]*See, e.g.,* ECJ 5. 3. 1996, C-46/93 and C-48/93, ECR 1996, I-1029, *Brasserie du Pêcheur* — para. 51 et. seq.; *cf.* Sepho, D., "Does the U.K.-U.S. Tax Treaty Conflict With the EC's Freedom of Establishment Principle?" *Tax Notes Int'l,* Oct. 20, 2003, p. 279.

[290]ECJ 5. 3. 1996, C-46/93 and C-48/93, ECR 1996, I-1029, *Brasserie du Pêcheur* — para. 55; ECJ 8.10.1996, C-178/94, ECR 1996, I-4845, *Dillenkofer* — para. 25.

[291]*See* ECJ 5. 3. 1996, C-46/93 and C-48/93, ECR 1996, I-1029, *Brasserie du Pêcheur* — para. 55 et. seq.

[292]ECJ 5. 3. 1996, C-46/93 and C-48/93, ECR 1996, I-1029, *Brasserie du Pêcheur* — para. 57.

[293]*See supra* I.A.

[294]*See, e.g.,* Sepho, D., "Does the U.K.-U.S. Tax Treaty Conflict With the EC's Freedom of Establishment Principle?" *Tax Notes Int'l,* Oct. 20, 2003, p. 279, which also considers the timing aspects of the open skies decisions, the issuance of the Commission's opinion regarding the nationality clauses in the open skies agreements, and the conclusion of the United Kingdom-United States DTC.

[295]ECJ 5. 3. 1996, C-46/93 and C-48/93, ECR 1996, I-1029, *Brasserie du Pêcheur* — para. 64.

by the tribunal.[296] By the means of state liability, subsidiaries of EU parent companies may indirectly benefit from preferential withholding tax rates in the DTC between that member state and the United States without complying with the LoB clause of that treaty. However, it should be noted that doubts persist and the question of state liability is unclear.[297]

As an alternative to claims under the principle of state liability and its stringent prerequisites, one can derive from the *Metallgesellschaft and Hoechst* case[298] an obligation of a member state to compensate for additional tax burdens triggered by the application of the LoB clause.[299] In those cases the ECJ has evaluated, *inter alia*, whether a breach of article 43 EC by a member state entitles taxpayers to a compensation or whether that sum could only be claimed, if at all, by an action for damages pursuant under the *Francovich* principles.[300] The Court relied on its well-established case law and held that the right to a refund of charges levied in a member state in breach of rules of EC law is the consequence and complement of the rights conferred on individuals by Community provisions as interpreted by the Court.[301] Therefore, a member state is in principle required to repay charges levied in breach of EC law,[302] including interest.[303] If those principles were transferred to the LoB issue, a member state may be obligated to reimburse a taxpayer, including interest, for withholding tax the United States has levied. That view is supported by the open skies decisions, in which the ECJ held that the source of that discrimination lies in entering into a treaty by the respective member state and therefore placed the liability on the respective contracting member states.[304]

V. Conclusion

Considering the open skies decisions, there is little doubt that the ownership requirements in LoB clauses in tax treaties between the United States and EU member states infringe on the freedom of establishment under articles 43 and 48 EC or on the free movement of capital under article 56 EC.[305] Neither the current concepts of derivative benefits nor the possibility of discretionary relief in a competent authority procedure will change the result. Furthermore, LoB clauses represent a disproportionate antiabuse measure, because they exceed what is required to counter treaty abuse to the detriment of fundamental freedoms, and will therefore not be justified under the rule of reason regardless of whether the United States could achieve the same result unilaterally. As a result, there may be an obligation of the respective member state under the *Francovich* principles of state liability or under the principles set forth by the ECJ in the *Metallgesellschaft and Hoechst* case[306] to compensate a taxpayer for additional tax burdens triggered by the application of a LoB clause. Finally, LoB clauses also raise issues under EC state aid principles, which may render the clauses incompatible with article 87 EC.[307] ✦

[296]*See also* Sepho, D., "Does the U.K.-U.S. Tax Treaty Conflict With the EC's Freedom of Establishment Principle?" *Tax Notes Int'l,* Oct. 20, 2003, p. 279.

[297]For recent negative or at least skeptical statements toward state liability in the LoB area *see, e.g.,* Terra, B. and P. Wattel, *European Tax Law*, 3rd ed., (2001) 114; Kemmeren, E., "The Netherlands," in Essers, P., G. de Bont, and E. Kemmeren (Eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties With EC Law* (1998) 125 (148 *et seq*.); *see also* Farmer, P., "EC Law and Direct Taxation — Some Thoughts on Recent Issues," *EC Tax J*. 1995/96, 91 (106), stating, from a 1995 perspective, that the "limitation of benefits issue can scarcely be considered obvious."

[298]ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst*.

[299]*See* Tumpel, M., "Der Einfluss der Grundfreiheiten des EG-Rechts auf die Doppelbesteuerungsabkommen," *ÖStZ* 2003/243, 154 (157); *cf.* Oliver, D.B., "Tax Treaties and the Market-State," 56 *Tax L. Rev.* 587 (601 *et seq*.) (2003); for a general discussion *see, e.g.,* Craig, A., "Show Me the Money: What the ECJ's Decision in *Hoechst* Could Mean for the United Kingdom's Tax Haven Legislation," *BIFD* 2002, 19 (19 *et seq*.); Eicker, K. and S. Müller, "Entscheidung des EuGH in Sachen Hoechst/Metallgesellschaft: Erwartungen nicht erfüllt," *RIW* 2001, 438 (441 *et seq*.).

[300]The case broke new ground, however, in that interest was the entire subject matter of the claim; since the discrimination lay in a prepayment, the taxpayers wanted to obtain a sum equal to the interest accrued on the advance payments made by the subsidiary from the date of those payments until the date on which the tax became chargeable.

[301]ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — para. 84; *cf.,* ECJ 9. 11. 1983, 199/82, ECR 1983, 3595, *San Giorgio* — para. 12; ECJ 9. 2. 1999, C-343/96, ECR 1999, I-579, *Dilexport* — para. 23; ECJ 21. 9. 2000, C-441/98 and C-442/98, ECR 2000, I-7145, *Michaïlidis* — para. 30.

[302]*See also* ECJ 9. 2. 1999, C-343/96, ECR 1999, I-579, *Dilexport* — para. 23; ECJ 21. 9. 2000, C-441/98 and C-442/98, ECR 2000, I-7145, *Michaïlidis* — para. 30.

[303]ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst* — paras. 86, 89.

[304]*See supra* II.C.

[305]The same is true for LoB clauses in intra-EU tax treaties; *see, e.g.,* Raventos, S., "Spain," in Essers, P., G. de Bont, and E. Kemmeren (Eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law* (1998) 173 (180 *et seq*.).

[306]ECJ 8. 3. 2001, C-397/98, C-410/98, ECR 2001, I-1727, *Metallgesellschaft and Hoechst*.

[307]*See* Panayi, C., "Open Skies for European Tax?" *BTR* 2003, 189 (201 *et seq*.); Panayi, C., "Limitation on Benefits and State Aid," *ET* 2004, 83 (87 *et seq*.).

Appendix I. Double Taxation Treaties Between the U.S. and EU Member States

Country	Title	Date Signed	General Effective Date	Official Text Symbol	Citation	Treasury Explan.
Austria	Convention Between the United States of America and the Republic of Austria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income	1996	1999	—	*(Doc 96-16362)*	*(Doc 96-25716)*
Belgium	Convention Between the United States of America and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (as amended by the Supplementary Protocol Modifying and Supplementing the Convention)	1970 (1987)	1971 (1988)	7463 TIAS (TIAS 11254)	1973-1 C.B. 619; 23 U.S.T. 2687 *(Doc 93-31302)*	*(Doc 93-30566F)*
Cyprus	Convention Between the United States of America and the Republic of Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income	1984	1986	TIAS 10965	1989-2 C.B. 280	1989-2 C.B. 314
Czech Republic	Convention Between the United States of America and the Czech Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital	1993	1993	—	*(Doc 93-11103)*	*(Doc 93-11123)*
Denmark	Convention Between the Government of the United States of America and the Government of the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income	1999	2001	—	*(1999 WTD 202-30)*	*(1999 WTD 211-21)*
Estonia	Convention Between the Government of the United States of America and the Republic of Estonia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income	1998	2000	—	*(1999 WTD 25-35)*	*(1999 WTD 209-26)*
Finland	Convention Between the Government of the United States of America and the Government of the Republic of Finland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income and On Capital	1989	1991	TIAS 12101	*(Doc 93-31203)*	*(Doc 90-4174)*
France	Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income and On Capital	1994	1996	—	*(Doc 94-9136)*	*(Doc 95-5893)*
Germany	Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income and On Capital and to Certain Other Taxes	1989	1990	—	*(Doc 93-31206)*	*(Doc 93-31207)*
Greece	Convention Between the United States of America and the Kingdom of Greece for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income	1950	1953	TIAS 2902	1958-2 C.B. 1054 *(Doc 93-30430)*	1954-2 C.B. 638 *(Doc 93-30667E)*

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Country	Title	Date Signed	General Effective Date	Official Text Symbol	Citation	Treasury Explan.
Hungary	Convention Between the Government of the United States of America and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income	1979	1980	TIAS 9560	1980-1 C.B. 333 *(Doc 93-30432)*	1980-1 C.B. 354 *(Doc 93-30671A)*
Ireland	Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income and Capital Gains (as amended by the Convention Amending the Convention)	1997 (1999)	1998 (2000)	—	*(Doc 97-32190)*	*(Doc 97-28089)*
Italy	Convention Between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes On Income and the Prevention of Fraud or Fiscal Evasion	1999	Pending	—	*(1999 WTD 202-31)*	*(1999 WTD 211-22)*
Latvia	Convention Between the United States of America and the Republic of Latvia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income	1998	2000	—	*(1999 WTD 25-37)*	*(1999 WTD 209-27)*
Lithuania	Convention Between the United States of America and the Republic of Lithuania for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income	1998	2000	—	*(1999 WTD 25-36)*	*(1999 WTD 210-21)*
Luxembourg	Convention Between the Government of the United States of America and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income and Capital	1996	2001	—	*(Doc 96-10286)*	*(Doc 96-25714)*
Malta	Agreement Between the United States of America and the Republic of Malta with Respect to Taxes On Income	1980	Termin. *(Doc 96-10740)*	TIAS 10567	*(Doc 93-30993)*	*(Doc 93-30714))*
Netherlands	Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income (as amended by the Protocol Amending the Convention)	1992 (1993)	1994	—	*(Doc 93-6037)* *(Doc 93-11106)*	*(Doc 93-11126)*
Poland	Convention Between the Government of the United States of America and the Government of the Polish People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income	1974	1974	TIAS 8486	1977-1 C.B. 416 *(Doc 93-30456)*	1977-1 C.B. 427 *(Doc 93-31061)*
Portugal	Convention Between the United States of America and the Portuguese Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income	1994	1996	—	*(Doc 94-30568)*	*(Doc 95-5894)*

Appendix I. Double Taxation Treaties Between the U.S. and EU Member States

Country	Title	Date Signed	General Effective Date	Official Text Symbol	Citation	Treasury Explan.
Slovak Republic	Convention Between the United States of America and the Slovak Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income and Capital	1993	1994	—	*(Doc 93-11105)*	*(Doc 93-11124)*
Slovenia	Convention Between the United States of America and the Republic of Slovenia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income and Capital	1999	2002	—	*(1999 WTD 202-33)*	*(1999 WTD 210-24)*
Spain	Convention Between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income	1990	1991	—	*(Doc 93-31216)*	*(Doc 1999-34698)*
Sweden	Convention Between the Government of the United States of America and the Government of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income	1994	1996	—	*(Doc 94-30655)*	*(Doc 95-5892)*
United Kingdom	Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income and On Capital Gains (as amended by the Protocol Amending the Convention)	2001 (2002)	2004	—	*(2001 WTD 143-14)*	*(2003 WTD 45-27)*

Appendix II. Limitation on Benefits Clauses in the Double Taxation Treaties Between the U.S. and EU Member States

		U.S. Model 1996	Austria	Belgium	Cyprus	Czech Republic	Denmark	Estonia	Finland	France	Germany	Greece	Hungary	Ireland
Treaty Effective Date		—	1999	1988	1986	1993	2001	2000	1991	1996	1990	1953	1980	1998
LoB Clause		Art 22	Art 16	Art 12A	Art 26	Art 17	Art 22	Art 22	Art 16	Art 30	Art 28	—	—	Art 23
Tests	Direct Stock Exchange Test	✔	✔	✔	—	✔	✔	✔	✔	✔	✔	—	—	✔
	Indirect Stock Exchange Test	✔	✔	✔	—	✔	✔	✔	—	✔	—	—	—	✔
	Ownership and Base Erosion Test	✔	✔	✔	✔	✔	✔	✔	✔	✔	✔	—	—	✔
	Active Trade or Business Test	✔	✔	✔	—	✔	✔	✔	✔	✔	✔	—	—	✔
Derivative Benefits Clause		—	—	—	—	—	✔	—	—	✔	—	—	—	✔
Competent Authority	Benefits Under Competent Authority	✔	✔	—	—	✔	✔	✔	✔	✔	✔	—	—	✔
	EU Considered (e.g., in MOU)	—	✔	—	—	—	—	—	✔	—	✔	—	—	—

		Italy	Latvia	Lithuania	Luxem-bourg	Malta	Nether-lands	Poland	Portugal	Slovak Republic	Slovenia	Spain	Sweden	United King-dom
Treaty Effective Date		Pending	2000	2000	2001	—	1994	1974	1996	1993	2002	1991	1996	2004
LoB Clause		Protocol	Art 23	Art 23	Art 24	—	Art 26	—	Art 17	Art 17	Art 22	Art 17	Art 17	Art 23
Tests	Direct Stock Exchange Test	✔	✔	✔	✔	—	✔	—	✔	✔	✔	✔	✔	✔
	Indirect Stock Exchange Stock	✔	✔	✔	✔	—	✔	—	✔	✔	✔	✔	—	✔
	Ownership and Base Erosion Test	✔	✔	✔	✔	—	✔	—	✔	✔	✔	✔	✔	✔
	Active Trade or Business Test	✔	✔	✔	✔	—	✔	—	✔	✔	✔	✔	✔	✔
Derivative Benefits Clause		—	—	—	✔	—	✔	—	—	—	—	—	—	✔
Competent Authority	Benefits Under Competent Authority	✔	✔	✔	✔	—	✔	—	✔	✔	✔	✔	✔	✔
	EU Considered (e.g., in MOU)	—	—	—	—	—	✔	—	—	—	—	—	—	✔

Appendix III. Timing Issues of the Preaccession Association of the New Member States With the EU and of the Tax Treaties Between the U.S. and the New Member States

New Member State	Official Application for EU Membership (1)	Preaccession Association With the EU			Accession to the EU				DTC With the U.S.		U.S. DTC in Force Before				
		Type of Agreement	Signed (2)	Entry Into Force (3)	Start of Negotiation (4)	Negotiation Concluded (5)	Treaty of Accession Signed	Accession	Signed	General Effective Date	(1)	(2)	(3)	(4)	(5)
Cyprus	Jul. 1990	Association Agreement	Dec. 1972	June 1973	Mar. 1998	Dec. 2002	Apr. 2003	May 2004	Mar. 1984	Jan. 1986	✔	—	—	✔	✔
Czech Republic	Jan. 1996	Europe Agreement	Oct. 1993	Feb. 1995	Mar. 1998	Dec. 2002	Apr. 2003	May 2004	Sept. 1993	Jan. 1993	✔	✔	✔	✔	✔
Estonia	Nov. 1995	Europe Agreement	June 1995	Feb. 1998	Mar. 1998	Dec. 2002	Apr. 2003	May 2004	Jan. 1998	Jan. 2000	—	—	—	—	✔
Hungary	Mar. 1994	Europe Agreement	Dec. 1991	Feb. 1994	Mar. 1998	Dec. 2002	Apr. 2003	May 2004	Feb. 1979	Jan. 1980	✔	✔	✔	✔	✔
Latvia	Oct. 1995	Europe Agreement	June 1995	Feb. 1998	Feb. 2000	Dec. 2002	Apr. 2003	May 2004	Jan. 1998	Jan. 2000	—	—	—	✔	✔
Lithuania	Dec. 1995	Europe Agreement	June 1995	Feb. 1998	Feb. 2000	Dec. 2002	Apr. 2003	May 2004	Jan. 1998	Jan. 2000	—	—	—	✔	✔
Poland	Apr. 1994	Europe Agreement	Dec. 1991	Feb. 1994	Mar. 1998	Dec. 2002	Apr. 2003	May 2004	Oct. 1974	Jan. 1974	✔	✔	✔	✔	✔
Slovakia	June 1995	Europe Agreement	Oct. 1993	Feb. 1995	Feb. 2000	Dec. 2002	Apr. 2003	May 2004	Oct. 1993	Jan. 1993	✔	✔	✔	✔	✔
Slovenia	June 1996	Europe Agreement	June 1996	Feb. 1999	Mar. 1998	Dec. 2002	Apr. 2003	May 2004	June 1999	Jan. 2002	—	—	—	—	✔
Malta	July 1990	Association Agreement	Dec. 1970	Apr. 1971	Feb. 2000	Dec. 2002	Apr. 2003	May 2004	—	—	—	—	—	—	—

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