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**A: Reconstructing the  
treaty network**



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## **Reconstructing the treaty network**

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## Summary and conclusions

European Union law overlaps and interacts with both the OECD's Base Erosion and Profit Shifting project (BEPS) and its implementation and the member states' tax treaties between them and with third countries, and there is also an area where all three fields meet. This intersection of EU law, BEPS and member states' (mostly) bilateral tax treaties is the subject of this report.

First, it should be noted that the Union's competence under article 115 TFEU not only covers purely internal situations, but the Union can also use its internal competence to specify the treatment of non-EU investors or third-country investments, and it has done so, e.g., in the Anti-Tax Avoidance Directive (ATAD). This has potential impact also on tax treaties between the member states and with third countries: Given the supremacy of EU (secondary) law, domestic law implementing Directives (e.g., the ATAD) might, under certain conditions, arguably take precedence over (pre- and post-accession) tax treaties between the member states, even if that implementation is detrimental to taxpayers and irrespective of whether the specific tax treaty was concluded before or after a provision of a Directive entered into force. As for tax treaties with third countries the TFEU contains a differentiating rule, as article 351 TFEU (ex-article 307 EC) grandfathers (only) member states' treaties with third countries, including tax treaties, that a member state concluded before 1 January 1958 or, for acceding states, before the date of their accession, so that EU law arguably takes precedence over post-accession tax treaties with third countries and, therefore, may directly affect the relevant member state's (but of course not the third country's) tax system.

Second, the European Commission has issued various Recommendations with regard to post-BEPS tax treaties of the member states. A 2012 Recommendation "on aggressive tax planning" addressed (also) tax treaty-based double non-taxation and encouraged member states to include an appropriate subject-to-tax clause in their double taxation conventions. The Commission's 2016 Recommendation dealt with the inclusion of a subject-to-tax clause in tax treaties, the definition of "permanent establishments" to prevent their artificial avoidance (article 5 OECD MC) and the use of an EU-compatible Principal Purposes Test (PPT), which refers to "a genuine economic activity" as a carve-out to align the clause with the case-law of the Court of Justice of the European Union as regards the abuse of law.

Third, the OECD BEPS project has established a (political) minimum standard regarding measures against treaty shopping (article 7 MLI and article 29 OECD MC), and the Limitation on Benefits (LoB) clause in particular raises issues with regard to its compatibility with the EU fundamental freedoms. In particular, LoB clauses are confronted with continuing doubts regarding their compatibility with the freedom of establishment. These concerns have also

<sup>1</sup> This report was prepared within and by the members of the ECJ Task Force of the CFE Tax Advisers Europe with the support of CFE Tax Advisers Europe's President, Piergiorgio Valente. Although this report has been drafted jointly within the ECJ Task Force, its content does not necessarily reflect the position of all members of the group.

found expression not only in various documents of the European Commission but also in the BEPS Action 6 Final Report, where the OECD noted that some countries may have “concerns based on EU law that prevent them from adopting the exact wording of the model provisions that are recommended in this report”, further specifying those concerns by recognizing “that the LOB rule will need to be adapted to reflect certain constraints or policy choices concerning other aspects of a bilateral tax treaty between two Contracting States” such as “concerns based on EU law”. Indeed, the “ownership clauses” in LoB provisions face scrutiny because the company’s residence state has agreed to give better conditions to companies held by shareholders resident in its own territory as compared to the ones resident elsewhere in the EU and the EEA. In such circumstances and in light of the *Open Skies* judgments, LoB clauses could thus be regarded as the immediate source of the discriminatory treatment. It is, however, unclear whether other – objective or subjective – tests in a typical LoB clause make them “EU compatible”, and if the source state’s perspective might require a different analysis in light of the ECJ’s decision in *ACT Group Litigation*.

Fourth, and while the OECD BEPS project has not established a minimum standard with regard to mandatory binding arbitration, the 2017 Tax Dispute Resolution Directive (TDRD) has established a mechanism for binding arbitration with regard to tax “disputes”. While the TDRD does not address double taxation outside of a tax treaty context, it is a huge step towards the removal of double taxation caused by diverging interpretation and application of tax treaties between member states.

Fifth, the OECD BEPS project has addressed situations of treaty-based non-taxation, which might also raise state aid questions under article 107 TFEU in cases where the misapplication of a tax treaty leads to “white income”. While generally “the need to avoid double taxation” would be a basis for a possible justification, it might indeed be asked if a double taxation convention must be interpreted, in light of article 107 TFEU, to not give rise to “white income” (e.g., through an unconditional exemption of untaxed income) or to “overcompensation” (e.g., through a tax sparing credit). That rather extreme path, however, was not (yet) taken by the Commission in the McDonald’s case: Indeed, to show selectivity, the Commission attempted merely to prove that Luxembourg had misapplied the applicable tax treaty. It did not rely on the alternative argument that double non-taxation resulting from the application of a tax treaty *ipso facto* amounts to state aid.

## 1. Introduction

European Union law overlaps and interacts with both the OECD’s Base Erosion and Profit Shifting project (BEPS) and its implementation<sup>2</sup> and the member states’ tax treaties between them and with third countries,<sup>3</sup> and there is also an area where all three fields meet. This

<sup>2</sup> See specifically S. Douma, “EU Report”, in: IFA (ed.), *Subject 1: Assessing BEPS: origins, standards and responses*, CDFI Volume 102a (2017), p. 65-89.

<sup>3</sup> For comprehensive analyses see, e.g., P. Pistone, *The Impact of Community Law on Tax Treaties: Issues and Solutions* (Kluwer, Alphen aan den Rijn, 2002), G. Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht* (Linde, Vienna, 2007), and E. Raingeard de la Blétière, *Les relations entre le droit communautaire et le droit fiscal international: nouvelles perspectives* (2008); E.C.C.M. Kemmeren, “Double Tax Conventions on Income and Capital and the EU: Past, Present and Future”, 21 *EC Tax Review* (2012), p. 157-177. For a recent overview of issues see Y. Brauner and G. Kofler, “Interaction of Tax Treaties with International Economic Laws”, in: R. Vann et. al. (eds.), *Global Tax Treaty Commentaries (GTTTC)*, IBFD Online Collection (2019).

intersection of EU law, BEPS and member states' (mostly) bilateral tax treaties is the subject of this report. It will deal with a variety of legal and policy issues:

- First, the relationship between EU law that implements BEPS measures, especially the Anti-Tax Avoidance Directive (ATAD),<sup>4</sup> and tax treaties between the member states and with third countries needs to be explored.
- Second, the European Commission (EC) has issued various Recommendations with regard to post-BEPS tax treaties of the member states. These deals, inter alia, with the inclusion of a subject-to-tax clause in tax treaties,<sup>5</sup> the definition of “permanent establishments” to prevent their artificial avoidance (article 5 OECD MC) and the use of an EU-compatible PPT approach.<sup>6</sup>
- Third, the OECD BEPS project has established a (political) minimum standard regarding measures against treaty shopping (article 7 of the Multilateral Instrument, MLI, and article 29 OECD MC).<sup>7</sup> However, both a Principal Purposes Test (PPT) and a Limitation on Benefits (LoB) clause raise issues with regard to their compatibility with the EU fundamental freedoms and EU tax policy. These issues need to be explored in light of the Commission's recommendation of an EU-compatible PPT approach<sup>8</sup> and the continuing doubts regarding the compatibility of LoB clauses with the freedom of establishment.<sup>9</sup>
- Fourth, the OECD BEPS project has established a minimum standard with regard to mutual agreement proceedings (e.g., articles 16 and 17 MLI),<sup>10</sup> but no such standard has been agreed with regard to mandatory binding arbitration.<sup>11</sup> In the EU, however, such binding arbitration is foreseen both in the multilateral 1990 Arbitration Convention for

<sup>4</sup> Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, [2016] OJ L 193, p. 1, as amended by Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, [2017] OJ L 144, p. 1.

<sup>5</sup> Commission Recommendation of 6 December 2012 on aggressive tax planning, [2012] OJ L 338, p. 41 (“2012 Recommendation”).

<sup>6</sup> Commission Recommendation (EU) 2016/136 of 28 January 2016 on the implementation of measures against tax treaty abuse, [2016] OJ L 25, p. 67 (“2016 Recommendation”).

<sup>7</sup> See OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report* (2015) (“BEPS Action 6 Final Report”), and also OECD, *BEPS Action 6 on Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Peer Review Documents* (2017); OECD, *Prevention of Treaty Abuse – Peer Review Report on Treaty Shopping: Inclusive Framework on BEPS: Action 6* (2019).

<sup>8</sup> Commission Recommendation (EU) 2016/136 of 28 January 2016 on the implementation of measures against tax treaty abuse, [2016] OJ L 25, p. 67.

<sup>9</sup> See for critical approaches, e.g., “Taxation: Commission asks the Netherlands to amend the Limitation on Benefits clause in the Dutch-Japanese Tax Treaty for the Avoidance of Double Taxation”, Case No 2014-4233, MEMO/15/6006 (19 November 2015), and the Commission Working Paper on “EC Law and Tax Treaties”, DOC(05) 2306 (9 June 2005), para. 19. For a detailed discussion of that issue, also in light of ECJ, 12 December 2006, C-374/04, *ACT Group Litigation*, EU:C:2006:773, see CFE ECJ Task Force, “Opinion Statement ECJ-TF 1/2018 on the Compatibility of Limitation-on-Benefits (LoB) Clauses with the EU Fundamental Freedoms”, 58 *European Taxation* (2018), p. 419-425.

<sup>10</sup> See OECD, *BEPS Action 14 on More Effective Dispute Resolution Mechanisms – Peer Review Documents* (2016), and the MAP Peer Review Reports.

<sup>11</sup> Rules on binding arbitration are foreseen in Part VI of the MLI, and a number of countries had already committed to a mandatory binding arbitration process; see the list of countries in OECD, *Making Dispute Resolution Mechanisms More Effective – Action 14 2015 Final Report* (2015), para. 62.

transfer pricing disputes<sup>12</sup> and the 2017 Tax Dispute Resolution Directive (TDRD),<sup>13</sup> which covers all tax “disputes”.<sup>14</sup>

- Fifth, and finally, may the (correct) application of a tax treaty that leads to double non-taxation trigger state aid scrutiny under article 107 TFEU? While generally “the need to avoid double taxation” would be a basis for a possible justification,<sup>15</sup> it might indeed be asked if a double taxation convention must be interpreted, in light of article 107 TFEU, to not give rise to “white income” (e.g., through an unconditional exemption of untaxed income) or to “overcompensation” (e.g., through a tax sparing credit).<sup>16</sup> That rather extreme path, however, was not (yet) taken by the Commission in the *McDonald’s* case.<sup>17</sup>

There are also potential areas of interest that are not dealt with in this report (e.g., the developments with regard to the automatic exchange of information outside tax treaties). Three of those more remote issues should, however, be mentioned:

- First, tax treaty issues were raised with regard to the EU Commission’s (failed) proposal for a “digital services tax” (DST), i.e., a 3% tax on the turnover from certain digital services rendered within the EU by large enterprises.<sup>18</sup> The focal point of the discussion related to the question whether such a tax, which was politically conceived as an “equalization levy” to collect tax revenues otherwise out of reach of the corporate tax systems, would nevertheless qualify as tax on “income” under article 2 OECD MC and hence put it at variance with the member states’ treaty obligations with third countries.<sup>19</sup>
- Second, EU law addressing BEPS issues might also lay down rules that avoid double taxation beyond what can be achieved under tax treaties. A concrete example is the obligation of member states to implement the exit taxation regime of article 5 ATAD and the avoidance of a potential (time-delayed) double taxation. While the OECD MC

<sup>12</sup> Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of transfers of profits between associated undertakings, [1990] OJ L 225, p. 10, as amended. See also the Revised Code of Conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, [2009] OJ C 322, p. 1.

<sup>13</sup> Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union, [2017] OJ L 265, p. 1.

<sup>14</sup> See, e.g., I. Richelle, “Dans les arcanes de la nouvelle directive sur le règlement des différends fiscaux”, in: J. Wildemeersch and P. Paschalidis (eds.), *L’Europe au présent ! – Liber Amicorum Melchior Wathelet* (Bruylant, Brussels, 2018), p. 883-927; G. Kofler, “EU Tax Dispute Resolution Directive: The Deathblow to Double Taxation in the European Union”, 28 *EC Tax Review* (2019), p. 266-269.

<sup>15</sup> See para. 139 of the Commission’s notice on the notion of State aid as referred to in art. 107(1) of the Treaty on the Functioning of the European Union, [2016] OJ C 262, p. 1.

<sup>16</sup> See, e.g., W. Haslechner, “Double Taxation Relief, Transfer Pricing Adjustments and State Aid Law”, in: I. Richelle, W. Schön & E. Traversa (eds.), *Allocating Taxing Powers within the European Union* (Springer, New York, 2013), p. 133, at p. 135-143.

<sup>17</sup> See the Commission Decision of 19 September 2018 on tax rulings SA.38945 (2015/C) (ex 2015/NN) (ex 2014/CP) granted by Luxembourg in favour of McDonald’s Europe, C(2018) 6076 final [19 September 2018]).

<sup>18</sup> Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM/2018/0148. No agreement on the DST was reached in December 2019 (Doc. 14885/18 FISC 510 ECOFIN 1148 [29 November 2018] and Doc. 14886/18 FISC 511 ECOFIN 1149 [29 November 2018]) and the proposal was subsequently confined to digital advertising services in March 2019 (Doc. 6873/19 FISC 135 ECOFIN 242 [1 March 2019]) and effectively given up in March 2019 (Doc. 7368/19 PRESSE 12 [12 March 2019]).

<sup>19</sup> For a detailed discussion and further references see D. Hohenwarter, G. Kofler, G. Mayr and J. Sinnig, “Qualification of the Digital Services Tax under Tax Treaties”, 47 *Intertax* (2019), p. 140-147.



does not provide for an automatic solution,<sup>20</sup> article 5(5) of the ATAD solves that issue by requiring the “import” state to give a step-up to the market value, i.e., “that Member State shall accept the value established by the Member State of the taxpayer or of the permanent establishment as the starting value of the assets for tax purposes [...]”.

- Third, the long-drawn discussion whether a “static” or an “ambulatory” (“dynamic”) approach to tax treaty interpretation should be taken with regard to the Commentaries to the OECD Model Tax Convention (OECD MC Comm.) has become even more relevant after the BEPS-induced amendments. Since the OECD MC Comm. is changed frequently without corresponding changes to the Model itself, it becomes relevant which version of the OECD MC Comm. should be used when interpreting an OECD MC-based tax treaty: The one existing at the time the concrete OECD-based tax treaty is applied (“ambulatory approach”)<sup>21</sup> or the one at the time the respective tax treaty was concluded (“static approach”, “frozen meaning”<sup>22</sup>)? Quite surprisingly, the ECJ might recently have endorsed an ambulatory (dynamic) use of the OECD MC Comm. in the “Danish beneficial ownership cases”<sup>23</sup> where it found that the tax treaty notion of “beneficial ownership” is relevant with regard to the interpretation of that concept in the 2003 Interest-Royalties-Directive (IRD).<sup>24</sup> In considering which guidance might be derived from the OECD MC Comm., the Court implicitly referred to the 1977 and 2003 versions of the OECD MC, the latter addressing certain conduit companies. The ECJ, however, did not (explicitly)<sup>25</sup> refer to the 2014 Update of OECD MC Comm., which brought significant changes to the treaty notion of “beneficial owner”. This might either imply that it did not want to go “fully dynamic” or that it did not consider it necessary. Moreover, the ECJ’s seemingly dynamic approach might not technically be “dynamic” at all: While the IRD was proposed in 1998, it was adopted in Council on 3 June 2003, whereas the 2003 OECD Update was already adopted by the OECD Council on 28 January 2003<sup>26</sup> and was based on an even earlier 2002 Report,<sup>27</sup> i.e. both were introduced before the IRD was passed. A dynamic approach, however,

<sup>20</sup> The OECD takes the position that a tax treaty does not prevent the application of that form of taxation, but also notes that “[t]he application of such taxes, however, creates risks of double taxation where the relevant person becomes a resident of another State which seeks to tax the same income at a different time, e.g. [...] when assets are sold to third parties”. See OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6–2015 Final Report* (2015), para. 66.

<sup>21</sup> See, e.g., Intro no. 3 and nos 33–36.1 and art. 5 no. 3 OECD MC Comm.

<sup>22</sup> See for that position, e.g., Austrian VwGH, 31 July 1996, 92/13/0172; German BFH, 8 December 2010, I R 92/09; Tax Court of Canada, 18 August 2006, *MIL (Investments) S A v. The Queen*, 2006 TCC 460; UK First Tier Tribunal, 12 April 2016, *Fowler v Revenue and Customs*, [2016] UKFTT 234 (TC) (“limited value”).

<sup>23</sup> Grand Chamber of the ECJ, 26 February 2019, C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg I, X Denmark, C Denmark I and Z Denmark*, EU:C:2019:134, and 26 February 2019, C-116/16 and C-117/17, *T Denmark and Y Denmark*, EU:C:2019:135.

<sup>24</sup> For discussion see CFE ECJ Task Force, “Opinion Statement ECJ-TF 2/2019 on the CJEU decisions of 26 February 2019 in C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg I et al.*, and C-116/16 and C-117/17, *T Denmark et al.*, concerning the “beneficial ownership” requirement and the anti-abuse principle in the company tax directives”, 59 *European Taxation* (2019), p. 487–502, at p. 498.

<sup>25</sup> It did, however, implicitly refer to a notion that was introduced by the 2014 Update of the OECD Model (the “in substance” criterion) in explaining the indicia for abuse. See ECJ, 26 February 2019, C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg I, X Denmark, C Denmark I and Z Denmark*, EU:C:2019:134, para. 132.

<sup>26</sup> As “The 2002 Update to the Model Tax Convention”.

<sup>27</sup> Entitled “Restricting the Entitlement to Treaty Benefits” (adopted by the OECD Committee on Fiscal Affairs on 7 Nov. 2002).



would not be surprising, as the ECJ in *Berlioz*<sup>28</sup> had already used the 2012 Commentaries on article 26 of the OECD Model<sup>29</sup> to interpret the concept of “foreseeable relevance” in the 2011 EU Mutual Assistance Directive.<sup>30</sup> It is, however, hard to see how such a dynamic understanding and attribution of “relevance” would fit into the EU legal order, since – as AG Kokott, who certainly prefers a static approach,<sup>31</sup> succinctly pointed out – “[o]therwise the contracting countries to the OECD would have the power to decide on the interpretation of an EU directive”.<sup>32</sup>

## 2. EU law, BEPS and “Treaty Overrides”

The European Union is a “player” in international tax policy also because it has legislative competences for binding positive tax integration, i.e., for harmonizing member states’ tax systems: It enjoys the competences conferred on it by the EU Treaties (“principle of conferral”; article 5 TFEU), such that competences in direct taxation within the European Union (an “internal market” matter) are shared between the European Union and the member states (article 4(2)(a) TFEU). Indeed, the general internal market competence that allows the issuance of “directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market” under (now) article 115 TFEU (ex-article 94 EC) has been used as the legal basis for a number of directives in the area of direct taxation, especially with regard to corporate taxation: It has been claimed by the Commission for its proposals for direct tax harmonization as early as 1969,<sup>33</sup> and these proposals as well all those made subsequently were and are based on what is now article 115 TFEU. While the “traditional” company tax directives (such as the Parent-Subsidiary Directive and the Interest-Royalty Directive) focus the internal market on the rights of the four freedoms and aim at removing tax distortions of the internal market, to allow enterprises to adapt to the requirements of the internal market and to improve their competitive strength at the international level, some directives approach the internal market through the lens of “practices of tax evasion and tax avoidance”.<sup>34</sup> This is not only true, e.g., for the directive on mutual assistance between tax administrations in the area of exchange of

<sup>28</sup> ECJ, 16 May 2017, C-682/15, *Berlioz Investment Fund SA*, EU:C:2017:373, para. 66.

<sup>29</sup> “Update to Article 26 of the OECD Model Tax Convention and its Commentary”, adopted by the OECD Council on 17 July 2012, and later included in the 2014 Update of the OECD MC, adopted by the OECD Council on 16 July 2014.

<sup>30</sup> Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, [2011] OJ L 64, p. 1.

<sup>31</sup> Opinions of AG Kokott of 1 March 2018 in C-115/16 (*N Luxembourg 1*, EU:C:2018:143, para. 52), C-118/16 (*X Denmark*, EU:C:2018:146, para. 52), and C-119/16 (*C Denmark I*, EU:C:2018:147, para. 52), noting that “[a]t most, should it transpire from the wording and history of the directive that the EU legislature was guided by the wording of an OECD Model Tax Convention and the commentaries (available at the time) on that OECD Model Tax Convention, a similar interpretation might be appropriate”.

<sup>32</sup> See, e.g., Opinion of AG Kokott of 1 March 2018, C299/16, *Z Denmark*, EU:C:2018:148, para. 53.

<sup>33</sup> See the proposals for the Parent-Subsidiary-Directive in COM(69)6 and for the Merger Directive in COM(69)5.

<sup>34</sup> It has been noted already in the 1970s that these practices extend across the frontiers of member states, they “lead to budget losses and violations of the principle of fair taxation and are liable to bring about distortions of capital movements and of conditions of competition”, and “therefore affect the operation of the common market”. See, e.g., the Preamble to the original Council Directive of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (77/799/EEC), [1977] OJ L 336, p. 15.

information (and its expansion in scope),<sup>35</sup> but also for the more recent developments with regard to substantive anti-tax avoidance measures (ATAD I and II).<sup>36</sup>

However, the Union's competence under article 115 TFEU not only covers purely internal situations, but the Union can also use its internal competence to specify the treatment of non-EU investors or third-country investments.<sup>37</sup> While some doubt that legally relevant distortions on the internal market can arise from third-country relations at all,<sup>38</sup> others argue that the Union's competence under article 115 TFEU may indeed be triggered because differences among the member states in their treatment of third-country investments may lead to distortions in the flow of investments and of competition in the internal market.<sup>39</sup> The latter notion also seems to be held by the Commission.<sup>40</sup> However, regulating the treatment of non-EU nationals in internal legislation may create conflicts with existing bilateral tax treaties (e.g., where a directive would ask for taxation where a treaty would foresee exemption).<sup>41</sup> This potential conflict becomes evident, e.g., with regard to the scope of application and a number of substantive provisions of the ATAD I<sup>42</sup> and II<sup>43</sup> (and in the

<sup>35</sup> Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, [2011] OJ L 64, p. 1 ("DAC1"), as amended.

<sup>36</sup> For doubts as to the Union's competence with regard to the ATAD see, e.g., I. Lazarov and S. Govind, "Carpet-Bombing Tax Avoidance in Europe: Examining the Validity of the ATAD Under EU Law", 47 *Intertax* (2019), p. 852-868.

<sup>37</sup> G. Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht* (Linde, Vienna, 2007), pp. 322-323; D. S. Smit, "The Influence of EU Tax Law on the EU Member States' External Relations", in: W. Haslehner, G. Kofler and A. Rust (eds.), *EU Tax Law and Policy in the 21st Century* (Kluwer, Alphen aan den Rijn, 2017), p. 215, at p. 221 and pp. 223-224.

<sup>38</sup> See, with regard to external competence, in this direction A. P. Dourado and P. Wattel in: P. Wattel, O. Marres and H. Vermeulen (eds.), *European Tax Law*, Volume 1, 7th edn (Kluwer, Alphen aan den Rijn, 2018), p. 209.

<sup>39</sup> See D. S. Smit, "The Influence of EU Tax Law on the EU Member States' External Relations", in: W. Haslehner, G. Kofler and A. Rust (eds.), *EU Tax Law and Policy in the 21st Century* (Kluwer, Alphen aan den Rijn, 2017), p. 215 (at p. 224).

<sup>40</sup> See, e.g., the Proposal for a Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements, COM(2017)335 (noting that "the actual level of protection of the internal market is overall defined by reference to the weakest Member State" and that, therefore, "a cross-border potentially aggressive tax planning arrangement that engages one Member State in reality impacts on all States").

<sup>41</sup> It does moreover call for an examination of whether it might lead to an (exclusive) external, treaty-making Union competence in the spheres covered by those acts. See for a detailed discussion, e.g., G. Kofler, "EU Power to Tax: Competences in the Area of Direct Taxation", in: C. HJI Panayi, W. Haslehner and E. Traversa (eds.), *Research Handbook on European Union Taxation Law* (Edward Elgar Publishing 2020) [in print]. This issue might also come on the political agenda in the future. See, e.g., the European Parliament resolution of 16 December 2015 with recommendations to the Commission on bringing transparency, coordination and convergence to corporate tax policies in the Union, P8\_TA(2015)0457 (16 December 2015), point AT(i) (noting that the "the Commission should be mandated to negotiate tax agreements with third countries on behalf of the Union instead of the current practice under which bilateral negotiations are conducted, which produce sub-optimal results").

<sup>42</sup> According to its art. 1, the ATAD (Council Directive (EU) 2016/1164, [2016] OJ L 193, p. 1) "applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country", i.e., also to third-country corporations with EU permanent establishments.

<sup>43</sup> See Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, [2017] OJ L 144, p. 1, which explicitly covers third-country situations.

proposals for the C(C)CTB<sup>44</sup>. And while the Union is generally careful not to interfere with tax treaties, one example for such potential conflict are the income inclusion rules under the controlled foreign company (CFC) regime of articles 7 and 8 ATAD. These also apply to a “permanent establishment of which the profits are not subject to tax or are exempt from tax in that member state”, i.e., to a low-taxed permanent establishment either located in another member state or a third country. By referring to profits that “are not subject to tax or are exempt from tax” in taxpayer’s member state, the ATAD might be viewed as obliging member states to effectuate a “treaty override” where a specific tax treaty would otherwise foresee an exemption (e.g., based on article 23A OECD MC).<sup>45</sup>

In any event, EU law has supremacy and thus prevails over domestic law and tax treaties.<sup>46</sup> This is also true for directives under article 288(3) TFEU, which are addressed to the member states and must be implemented by them.<sup>47</sup> Domestic law implementing directives (e.g., the ATAD) might therefore arguably take precedence over (pre- and post-accession) tax treaties between the member states,<sup>48</sup> even if that implementation is detrimental to taxpayers and irrespective of whether the specific tax treaty was concluded before or after a provision of a directive entered into force;<sup>49</sup> however, it is not fully clear if states whose constitutional framework prohibits “treaty overrides” would rather be obligated to additionally amend or terminate their tax treaties to give full effect to the directive’s implementation into domestic law.<sup>50</sup> As for tax treaties with third countries, however, the TFEU contains a differentiating rule: Article 351 TFEU (ex-article 307 EC) grandfathered (only) member states’ treaties with third countries, including tax treaties,<sup>51</sup> that a member state concluded before 1 January 1958 or, for acceding states, before the date of their accession. Under article 351 TFEU, the “rights and obligations” arising from such agreements “shall not be affected by the provisions of the Treaties”. This, *a fortiori*, means that EU law takes precedence over post-accession tax treaties with third countries and, therefore, may directly affect the relevant member state’s

<sup>44</sup> That concerns the scope of application as well as substantive provisions. Under art. 2(2) of the Commission’s proposal for a CCTB (COM(2016)685), that Directive would, under certain conditions, also “apply to a company that is established under the laws of a third country in respect of its permanent establishments situated in one or more Member State”. Likewise, third-country situations are, e.g., addressed in the area of anti-abuse provisions under arts. 59 and 61 of the Commission’s proposal with regard to CFC rules and hybrid mismatches.

<sup>45</sup> For the substantive, third-state relevant provisions of the ATAD see the overview by W. Haslehner, “EU-US Relations in the Field of Direct Taxes from the EU Perspective: A BEPS-Induced Transformation?”, in: P. Pistone and D. Weber (eds.), *Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* (IBFD, Amsterdam, 2018), Ch. 3.3.

<sup>46</sup> ECJ, 5 February 1963, 26/62, *van Gend & Loos*, EU:C:1963:1.

<sup>47</sup> ECJ, 17 December 1970, 11/70, *Internationale Handelsgesellschaft*, EU:C:1970:114.

<sup>48</sup> See, e.g., ECJ, 14 February 1984, 278/82, *Rewe*, EU:C:1984:59, para. 29; ECJ, 27 September 1988, 235/87, *Matteucci*, EU:C:1988:412, para. 14 and 20–21. It should be noted, however, that an intensive discussion exists whether taxpayers can rely on tax treaty (e.g., with regard to a reduced withholding tax rate) notwithstanding the fact that the more beneficial reduction under domestic implementing law (e.g., implementing the withholding tax exemption of the Parent-Subsidiary-Directive) is not granted because of abuse; the Dutch Supreme Court recently held so and granted the reduced treaty withholding rate despite denying the withholding tax exemption under the Dutch implementation of the Parent-Subsidiary-Directive (see Hoge Raad, 10 January 2020, 18/00219, NL:HR:2020:21).

<sup>49</sup> See, e.g., ECJ, 10 November 1992, C-3/91, *Exportur*, EU:C:1992:420, para. 8, and, with further references, G. Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht* (Linde, Vienna, 2007), p. 272.

<sup>50</sup> See for that perspective E.C.C.M. Kemmeren, *Principle of Origin in Tax Conventions – A Rethinking of Models* (2001), p. 233–234.

<sup>51</sup> See, e.g., the Commission’s Working Paper on “EC Law and Tax Treaties”, DOC(05) 2306 (9 June 2005), para. 15–19.

(but of course not the third country's) tax system (again perhaps conditional on the domestic approach "treaty overrides"). Indeed, article 351 TFEU merely aims at protecting the rights of third states (and, *vice versa*, the obligations of member states) in compliance with international public law.<sup>52</sup> However, it also calls on member states to "take all appropriate steps to eliminate the incompatibilities established", including, where necessary, by denouncing the bilateral agreement. With regard to the Union's internal competence, the ECJ applies article 351 TFEU not only in situations where provisions of a pre-accession tax treaty are incompatible with the "provisions of the Treaties", i.e., primary law,<sup>53</sup> but also when provisions of a pre-accession tax treaty become substantively incompatible with a subsequent directive.<sup>54</sup> It is, however, unclear if a member state's post-accession tax treaties with third countries are also covered through an analogous application of article 351 TFEU if those bilateral tax treaties have been compliant with Union law, but subsequently became substantively incompatible with a directive.<sup>55</sup> Given those uncertainties and also the unclear scope of potential consequences,<sup>56</sup> it is quite welcome that the Commission makes attempts to take tax treaties into account in its proposals.<sup>57</sup>

<sup>52</sup> See, e.g., ECJ, 11 March 1986, 121/85, *Conegate*, EU:C:1986:114, paras 24-25; ECJ, 10 March 1998, C-364/95 and C-365/95, *T. Port GmbH & Co.*, EU:C:1998:95, para. 60; ECJ, 16 May 2017, Opinion 2/15 ("Singapore"), EU:C:2017:376, para. 254.

<sup>53</sup> See, e.g., ECJ, 14 January 1997, C-124/95, *Centro-Com*, EU:C:1997:8, paras. 56-61.

<sup>54</sup> ECJ, 2 August 1993, C-158/91, *Jean-Claude Levy*, EU:C:1993:332.

<sup>55</sup> That issue was, e.g., explicitly left open in the Opinion of AG J. Kokott, 13 March 2008, C-188/07, *Total France*, EU:C:2008:174, paras 94-98.

<sup>56</sup> See W. Haslehner, "EU-US Relations in the Field of Direct Taxes from the EU Perspective: A BEPS-Induced Transformation?", in: P. Pistone and D. Weber (eds.), *Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* (IBFD, Amsterdam, 2018), Chapter 3.5.2.

<sup>57</sup> See, e.g., art. 53 of the Commission's proposal for a CCTB, COM(2016)685, under which the switch-over clause will "not apply where a convention for the avoidance of double taxation between the Member State in which the taxpayer is resident for tax purposes and the third country where that entity is resident for tax purposes does not allow switching over from a tax exemption to taxing the designated categories of foreign income". Another example is, e.g., the Commission's proposal for a significant digital presence (COM(2018)147), where art. 2 specifies that the directive would, "in the case of entities that are resident for corporate tax purposes in a third country with which the particular Member State in question has a convention for the avoidance of double taxation", only apply "if that convention includes provisions similar to Articles 4 and 5 of this Directive in relation to the third country and those provisions are in force". Complementing this delimitation of the directive's scope, the Commission has simultaneously issued a recommendation to member states to (bilaterally) amend their tax treaties with third countries and to include provisions on significant digital presences (see the Commission's Recommendation of 21.3.2018 relating to the corporate taxation of a significant digital presence, C(2018)1650). Another example is art. 9(5) ATAD 2 (Council Directive (EU) 2017/952, [2017] OJ L 144, p. 1), which generally provides that, "[t]o the extent that a hybrid mismatch involves disregarded permanent establishment income which is not subject to tax in the Member State in which the taxpayer is resident for tax purposes, that Member State shall require the taxpayer to include the income that would otherwise be attributed to the disregarded permanent establishment", but also postulates that this does not apply if "the Member State is required to exempt the income under a double taxation treaty entered into by the Member State with a third country".

### 3. BEPS and EU Recommendations on Post-BEPS tax treaties

#### 3.A. Introduction

The European Commission 2016 Recommendation “on the implementation of measures against tax treaty abuse”<sup>58</sup> appears as the “tax treaty prong” of the 2016 EC’s comprehensive plan against corporate tax abuse, the EU’s 2016 Anti-Tax Avoidance Package (ATAP).<sup>59</sup> Even though the ATAP was adopted shortly after the final BEPS reports had been issued in October 2015,<sup>60</sup> its scope is more limited. This explains why this tax treaty prong of the ATAP does not refer to all BEPS actions dealing with treaties (Actions 2, 6, 7 and 14) but only to those dealing with substantive corporate tax issues: Action 6 (“Preventing the Granting of Treaty Benefits in Inappropriate Circumstances”)<sup>61</sup> and Action 7 (“Preventing the Artificial Avoidance of Permanent Establishment Status”)<sup>62</sup>. The ATAP required or recommended action at all levels: domestic, EU and international (tax treaties). For the latter, directives would not be appropriate (namely because most of the tax treaty network of member states refers to treaties with third countries). In this context, the 2016 Recommendation, a non-binding (“soft”), secondary law instrument under article 288(5) TFEU, appeared to be a viable option. The 2016 Recommendation is addressed to the EU member states. However, this one has a *vis expansiva* as it aims to be applied in all treaties signed by member states (including those signed with third countries).

It should be noted in passing that even before the BEPS project the European Commission had issued a Recommendation “on aggressive tax planning” in 2012, in which it addressed (also) tax treaty-based double non-taxation: It recommended that “[w]here Member States, in double taxation conventions which they have concluded among themselves or with third countries, have committed not to tax a given item of income, Member States should ensure that such commitment only applies where the item is subject to tax in the other party to that convention”. To that end the Commission encouraged member states to include an appropriate clause in their double taxation conventions.<sup>63</sup>

<sup>58</sup> Commission Recommendation (EU) 2016/136 of 28 January 2016 on the implementation of measures against tax treaty abuse, [2016] OJ L 25, p. 67 (“2016 Recommendation”).

<sup>59</sup> See [https://ec.europa.eu/taxation\\_customs/business/company-tax/anti-tax-avoidance-package\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en) (last access 31 January 2020).

<sup>60</sup> A direct reference can be found in para 6 of the 2016 Recommendation’s preamble.

<sup>61</sup> OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report* (2015) (“BEPS Action 6 Final Report”).

<sup>62</sup> OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report* (2015), p. 42–43 (“BEPS Action 7 Final Report”).

<sup>63</sup> The wording suggested in point 3.2 of the 2012 Recommendation reads: “Where this Convention provides that an item of income shall be taxable only in one of the contracting States or that it may be taxed in one of the contracting States, the other contracting State shall be precluded from taxing such item only if this item is subject to tax in the first contracting State”. For a critical analysis see, e.g., M. Lang, “Aggressive Steuerplanung” – eine Analyse der Empfehlung der Europäischen Kommission”, 23 *Steuer und Wirtschaft International* (2013), p. 62 et seq.

### 3.B. Recommendation on an EU-compliant Principal Purposes Test

The first part of the 2016 Recommendation concerns the proposed changes regarding abuse of treaties in the BEPS Action 6 Final Report. The Preamble of the Recommendation makes an explicit reference to both an amendment of treaties' preambles and an introduction of a general anti-abuse rule based on an EU-compliant "principal purpose test" (PPT).<sup>64</sup>

Nonetheless, the "operative" part of the Recommendation ignores the preamble part and is limited to the introduction of a general anti-avoidance rule based on a principal purpose test (PPT). It is difficult to understand the reasons behind such a restriction. Particularly considering that in the framework of the BEPS Action 6 Final Report, the amendment of the treaty preamble is considered a minimum standard.<sup>65</sup> Moreover, the operative part of the Recommendation refers to only one of the modalities for meeting the minimum standard. One should recall that BEPS Action 6 allowed three options to meet the minimum standard,<sup>66</sup> i.e., (i) the inclusion of a PPT rule,<sup>67</sup> (ii) the inclusion of a simplified Limitation-on-Benefits (LOB) rule<sup>68</sup> together with a PPT rule, or (iii) the inclusion of a detailed LOB rule<sup>69</sup> together with a provision dealing with conduit arrangements that are not dealt with in tax treaties.<sup>70</sup>

The operative part of the 2016 Recommendation proposes a deviation in what concerns the PPT rule as proposed by the OECD. In the version recommended by the European Commission, benefits of the convention could be granted not only where it is considered to be "in accordance with the object and purpose" of the respective tax treaty but also<sup>71</sup> to situations where the claimed benefit "reflects a genuine economic activity". The recommended wording (with the proposed deviation in *italics*) is:

Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that it reflects a *genuine economic activity* or that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

The Commission explains that this deviation was introduced to ensure "compliance with EU Law" and is based on the assumption that the OECD's PPT clause "needs to be aligned with the case-law of the Court of Justice of the European Union as regards the abuse of law"<sup>72</sup>. This deviation raises some issues. This deviation introduces a fundamental concern that may not have been taken into account by the European Commission: An entity or transaction may be absolutely genuine but, nevertheless, be used to obtain a benefit that falls outside the treaty's object and purpose. In these cases, the OECD is clear and considers that the mere infringement of the treaty object and purpose is enough to disqualify the entity or transaction. Understood

<sup>64</sup> Para 3 of the 2016 Recommendation.

<sup>65</sup> See paras 22 and 23 of the BEPS Action 6 Final Report.

<sup>66</sup> Paras 19 and 22 of the BEPS Action 6 Final Report.

<sup>67</sup> As mentioned in para. 26 BEPS of the BEPS Action 6 Final Report.

<sup>68</sup> Para. 25 of the BEPS Action 6 Final Report.

<sup>69</sup> Para. 25 of the BEPS Action 6 Final Report.

<sup>70</sup> Paras 19 and 22 of the BEPS Action 6 Final Report.

<sup>71</sup> The conjunction "or" indicates that this is a second prong in the application of the test.

<sup>72</sup> Para. 7 of the Preamble of the 2016 Recommendation.



in this sense, the deviation proposed by the European Commission would decrease the level of protection against treaty abuse required by the OECD. Considering that all EU member states (out of the three available options for meeting the minimum standard) opted for the PPT, this situation leads to a conundrum. States opting for being compliant with the 2016 Recommendation would not be OECD compliant; States opting for implementing the OECD PPT rule without deviation would not be compliant with the 2016 Recommendation. This may be the reason why all EU member states decided to ignore the deviation proposed by the Commission. A careful examination of the full treaty network<sup>73</sup> reveals that no member state includes (or plans to include) such deviation in its tax treaties.<sup>74</sup>

### 3.C. Recommendation on the definition of “permanent establishment”

The second part of the 2016 Recommendation concerns the BEPS proposed changes regarding the PE definition. The preamble of the 2016 Recommendation<sup>75</sup> expresses the need to amend tax treaties to prevent (i) the avoidance of a permanent establishment through commissionaire arrangements and similar structures and (ii) the “abuse” of the exceptions concerning preparatory or auxiliary activities. Nonetheless, and unlike the previous one, this second Recommendation makes a full and unrestricted remission to the conclusions of the BEPS Action 7 Final Report, “encouraging” Member States to adopt them in their full treaty network:

Member States are encouraged, in tax treaties which they conclude among themselves or with third countries, to implement and make use of the proposed new provisions to Article 5 of the OECD Model Tax Convention in order to address artificial avoidance of permanent establishment status as drawn up in the final report on Action 7 of the Action Plan to address Base Erosion and Profit Shifting (BEPS).

### 3.D. Follow-up by the European Commission

The Commission has not established or suggested a time frame for the implementation of the 2016 Recommendation.<sup>76</sup> The same occurred at the OECD level, where BEPS Actions were generally silent in this regard, even those that included minimum standards.<sup>77</sup> For the Commission and at the moment of the Recommendation, it was enough to require member states to inform it of any measures related with the implementation, stating that a report would be published “within three years after its adoption”. As the Recommendation was

<sup>73</sup> Using IBFD's tax treaty research platform, available at <https://research.ibfd.org/#/> (last accessed 1 January 2020)

<sup>74</sup> The Austria-France Tax Treaty (1993) makes reference to “genuine economic reasons”. However, this cannot be seen as an implementation of the EC recommendation since (i) the expression is used in the framework of the provision regarding taxation of capital gains and (ii) the treaty provision dates from 1993, more than two decades before the adoption of the recommendation.

<sup>75</sup> Para.4. of the 2016 Recommendation.

<sup>76</sup> Which is in line with prior recommendations in direct tax matters.

<sup>77</sup> For instance, para. 23 of the BEPS Action 6 Final Report stated: “Since the conclusion of a new treaty and the modification of an existing treaty depend on the overall balance of the provisions of a treaty, however, this commitment should not be interpreted as a commitment to conclude new treaties or amend existing treaties within a specified period of time”.



adopted in January 2016, this report should have been published in January 2019. However, one year later, nothing has yet been published. The Commission requested the member states to inform not only of the implementing measures but also of “any changes made to such measures”. In our view, this would cover not only the measures adopted in the strict implementation of the Recommendation but all treaty measures falling down the objective scope of the Recommendation, i.e. any changes on the PE definition and on a treaty GAAR. However, in the absence of further clarification and of the publication of the follow-up report, it is difficult to understand what the Commission wanted and what it is effectively monitoring in this regard.

## 4. Treaty shopping and EU law

### 4.A. Introduction

Countering abusive and fraudulent practices is a well-established principle of European Union law.<sup>78</sup> Therefore, insofar as EU law is applicable (e.g., within the scope of a company tax directive), all member states must counter such practices, including so-called “directive shopping”. Anti-avoidance issues also arise with regard to tax treaties, especially with regard to treaty shopping. Treaty shopping generally involves the establishment of an intermediate holding company in a state with tax treaties with both the state of residence of the investor, and with that of a source of profit, in order to get a more favourable regime than if the investor had received the profit directly. Countering such treaty shopping must, however, conform to all other EU law principles and rules, since otherwise the primacy of European over domestic and treaty law<sup>79</sup> would be undermined.

These EU law obligations might, however, lead to tensions with the OECD BEPS Action 6 political “minimum standard”, which is now reflected in article 7 MLI and article 29 OECD MC 2017.<sup>80</sup> Indeed, both a Principal Purposes Test (PPT) and a Limitation on Benefits (LoB) clause raise issues with regard to their compatibility with the EU fundamental freedoms and EU tax policy that need to be explored in light of the Commission’s 2016 Recommendation of an EU-compatible PPT approach<sup>81</sup> and the continuing doubts regarding the compatibility of

<sup>78</sup> See ECJ, 26 February 2019, C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg 1 et al.*, EU:C:2019:134, para. 101; ECJ, 26 February 2019, C-116/16 and C-117/16, *T Danmark et al.*, EU:C:2019:135, para. 75.

<sup>79</sup> See *supra* ch. 2. It should be remembered that, from the perspective of European Union law, also tax treaties are part of national legislation. Therefore, EU member states may not invoke the application of a treaty to overcome the primacy of supranational legislation of the European Union, except for those treaties that were signed before its establishment, or, for the non-founding member states, their date of accession (see art. 351 (1) TFEU). In some situations, also involving treaties concludes with non-EU member states, this has generated conflicts. In some circumstances, the Court of Justice has obliged member states to ensure an equivalent treatment by means of their domestic legislation (see ECJ, 21 September 1999, C-307/97, *Saint-Gobain ZN*, EU:C:1999:438); in others, by *de facto* obliging them to either terminate the treaties, or find alternative solutions, including at EU level, in order to remove the problem (see ECJ, 5 November 2002, C-466/98 *et al.*, *Commission v. United Kingdom et al.*, EU:C:2002:624).

<sup>80</sup> See for that “minimum standard” already *supra* ch. 3.

<sup>81</sup> Commission Recommendation (EU) 2016/136 of 28 January 2016 on the implementation of measures against tax treaty abuse, [2016] OJ L 25, p. 67.

LoB clauses with the freedom of establishment.<sup>82</sup> These concerns have also found expression in the BEPS Action 6 Final Report, where the OECD noted that some countries may have “concerns based on EU law that prevent them from adopting the exact wording of the model provisions that are recommended in this report”,<sup>83</sup> further specifying those concerns by recognizing “that the LOB rule will need to be adapted to reflect certain constraints or policy choices concerning other aspects of a bilateral tax treaty between two Contracting States” such as “concerns based on EU law”.<sup>84</sup>

#### 4.B. Limitation on Benefits clauses (LoB)

A simplified Limitation on Benefits (LoB) clause under article 7(6)-(13) MLI and article 29(1)-(7) OECD MC has undoubted merits insofar as it outlines the qualified persons entitled to treaty benefits alongside criteria that reflect their low exposure to treaty shopping<sup>85</sup> and applies objective tests and sub-tests that allow for excluding potential cases (e.g., “active conduct of a business”, derivative benefits, companies traded on a stock exchange). However, the main EU law compatibility issue of a simplified LoB clause is that its “ownership clause” generally requires that resident entities only qualify for treaty benefits if at least 50% of their shares are held by other qualified persons (e.g., individuals resident in one of the contracting states or companies traded on a recognized stock exchange), so that other entities are excluded unless they meet one of the other objective tests (e.g., the “active conduct of a business” test) or receive discretionary relief. Such “ownership clause” may, however, lead to different treatment as between EU companies controlled by residents of a contracting member state and those controlled by residents of a non-contracting member state,<sup>86</sup> i.e., it can deprive a company resident in a member state, which is controlled by residents of another member state, of entitlement to the benefits of tax treaties that it would otherwise enjoy along with other residents of the former member state. Since the reason for that disadvantageous treatment typically coincides with the exercise of a fundamental freedom, i.e., the right of an EU national or EU company to establish a subsidiary in another member state, such problems may be regarded as the source of a substantive obstacle when the application of LoB clauses completely excludes the exercise of such right in the case of a genuine practice, or

<sup>82</sup> See for critical approaches, e.g., “Taxation: Commission asks the Netherlands to amend the Limitation on Benefits clause in the Dutch-Japanese Tax Treaty for the Avoidance of Double Taxation”, Case No 2014-4233, MEMO/15/6006 (19 November 2015), and the Commission Working Paper on “EC Law and Tax Treaties”, DOC(05) 2306 (9 June 2005), para. 19. For a detailed discussion of that issue, also in light of ECJ, 12 December 2006, Case C-374/04, *ACT Group Litigation*, EU:C:2006:773, see CFE ECJ Task Force, “Opinion Statement ECJ-TF 1/2018 on the Compatibility of Limitation-on-Benefits (LoB) Clauses with the EU Fundamental Freedoms”, 58 *European Taxation* (2018), p. 419-425.

<sup>83</sup> BEPS Action 6 Final Report, p. 14.

<sup>84</sup> BEPS Action 6 Final Report, p. 19 (para. 21).

<sup>85</sup> Such as in the case of individuals, contracting states, their political subdivisions, agencies and instrumentalities, publicly traded companies and entities (including the related affiliates), non-profit organisations and recognized pension funds, and in some cases of collective investment vehicles.

<sup>86</sup> See already the critical approach in the Commission Working Paper on “EC Law and Tax Treaties”, DOC(05) 2306 (9 June 2005), para. 19.

of a procedural one, when their application makes it more burdensome.<sup>87</sup> The compatibility issue therefore does not affect the goal of LoB clauses, which also matters for EU law, but rather how this type of instrument achieves such goal and, more specifically, the impact that the instrument may have on the exercise of genuine rights protected by EU primary law.

Despite the extremely diversified range of LoB clauses, all of them share one structural problem, which has prompted the European Commission to a critical position already in 2005<sup>88</sup> and to initiate an investigation on the compatibility of an LoB clause with EU law in a case concerning the tax treaty between Japan and the Netherlands in 2015.<sup>89</sup> Indeed, the Reasoned Opinion of the EU Commission finds this specific problem in the fact that the Netherlands has agreed to give better conditions to companies held by shareholders resident in its own territory and to companies traded on its stock exchanges as compared to the ones resident or traded elsewhere in the EU and EEA. In such circumstances, LoB clauses are thus to be regarded as the immediate source of the discriminatory treatment. The Commission argues:

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

The specific consequence of the application of the LoB clause is therefore that the exclusion of such entities from the application of the double tax treaty makes the interest and royalties received from Japan by foreign-owned Dutch companies more heavily taxed than they would otherwise be, thus producing potential dissuasive effect on the exercise of the right of establishment of EU nationals into the Netherlands, or of the free movement of capital even in relations with third countries.<sup>90</sup> Indeed, and as the Commission has pointed out,

<sup>87</sup> For a detailed analysis and further references see CFE ECJ Task Force, "Opinion Statement ECJ-TF 1/2018 on the Compatibility of Limitation-on-Benefits (LoB) Clauses with the EU Fundamental Freedoms", 58 *European Taxation* (2018), p. 419-425.

<sup>88</sup> Commission Working Paper on "EC Law and Tax Treaties", DOC(05) 2306 (9 June 2005), para. 19.

<sup>89</sup> See "Taxation: Commission asks the Netherlands to amend the Limitation on Benefits clause in the Dutch-Japanese Tax Treaty for the Avoidance of Double Taxation" in the Commission's Fact Sheet "November infringements package: key decisions", MEMO/15/6006 (19 November 2015). Until present, there has been no development in this investigation, but the Commission has not closed this file.

<sup>90</sup> While the entitlement to the right of establishment only operates in favor of EU nationals and within the EU internal market, EU law protects free movement of capital under art. 63 ff. TFEU regardless of nationality within the EU internal market and, on a unilateral basis, also in relations with third countries regardless of the nationality.

there is a structural similarity between LoB clauses and the nationality clauses contained in air traffic agreements concluded by several EU member states with the US in the *pre-Open Skies* era, i.e., before the EU liberalization of air traffic routes and the conclusion of an EU-US agreement,<sup>91</sup> which the Court of Justice has regarded as incompatible with the EU right of establishment.<sup>92</sup> If one were to follow that line of reasoning, the issue is that a member state may not agree in its treaties with third countries a better treatment for companies held by shareholders resident in its own territory, than for comparable companies held by non-resident ones, and that such a situation would still prevail if certain “equivalent beneficiaries” under a so-called “derivative benefits” clause were included. Notwithstanding this, however, it is also under discussion whether other – objective or subjective – tests in a typical LoB clause make them “EU compatible”.

A similar yet different compatibility issue may arise if the state of source is an EU member state that effectively deprives residents of the other contracting state of the entitlement to the benefits of the tax treaty based on an “ownership clause”, i.e., based on whether they are controlled by qualifying shareholders of either contracting state. This issue was addressed by the ECJ in the rather complex *ACT Group Litigation* case,<sup>93</sup> with regard to the operation of the “ownership test” of the LoB in the Netherlands-United Kingdom tax treaty, according to which certain benefits granted by the source state (i.e., the UK) were denied to the recipient of a dividend in the residence state (i.e. a Netherlands entity) because its sole shareholder was resident in a third member state (i.e. Germany). The ECJ dealt with this issue in light of a horizontal discrimination analysis and held that the LoB clause at issue did not infringe upon the freedom of establishment:

Thus, the grant of a tax credit to a non-resident company receiving dividends from a resident company, as provided for under a number of DTCs concluded by the United Kingdom, cannot be regarded as a benefit separable from the remainder of those DTCs, but is an integral part of them and contributes to their overall balance (see, to that effect, [EC], 5 July 2005, C-376/03, D, EU:C:2005:424], paragraph 62). [...] The same applies to the provisions of the DTCs which make the grant of such a tax credit subject to the condition that the non-resident company is not owned, directly or indirectly, by a company resident in a Member State or a non-member country with which the United Kingdom has concluded a DTC which does not provide for such a tax credit. [...] Even where such provisions extend to the situation of a company which is not resident in one of the contracting Member States, they apply only to persons resident in one of those Member States and, by contributing to the overall balance of the DTCs in question, are an integral part of them.<sup>94</sup>

While it is still not entirely clear that the ECJ in *ACT Group Litigation* wanted to give *carte blanche* to source member states to apply “ownership clauses”,<sup>95</sup> other precedents addressing the

<sup>91</sup> The EU-US Open Skies Agreement was signed in Washington DC on 30 April 2007.

<sup>92</sup> See the (non-tax) judgments ECJ, 5 November 2002, C-466/98 et al., *Commission v. United Kingdom et al.*, EU:C:2002:624 ff. Furthermore, the EU Commission has also invoked another non-tax law precedent, namely ECJ, 15 January 2002, C-55/00, *Gottardo*, EU:C:2002:16.

<sup>93</sup> ECJ, 12 December 2006, C-374/04, *ACT Group Litigation*, EU:C:2006:773.

<sup>94</sup> ECJ, 12 December 2006, C-374/04, *ACT Group Litigation*, EU:C:2006:773, paras 88–90.

<sup>95</sup> For critical discussion see, e.g., CFE ECJ Task Force, “Opinion Statement ECJ-TF 1/2018 on the Compatibility of Limitation-on-Benefits (LoB) Clauses with the EU Fundamental Freedoms”, 58 *European Taxation* (2018), p. 423–425.

residence member state that has agreed to them, such as *Gottardo*<sup>96</sup> and *Open Skies*,<sup>97</sup> rather clearly imply that those clauses might indeed be considered a relevant discrimination and potential infringement of the freedom of establishment that would require a justification, e.g., based on the attempt to counter abusive practices, and must be proportionate. As for the latter, the principle of proportionality requires a case-by-case analysis, which gives the taxpayers a right to prove the genuine nature of their transactions and accordingly protects the exercise of their rights, as granted by EU law. This prevents EU law from using irrefutable (so-called *iuris et de iure*) presumptions, for their overkill effects on genuine practices,<sup>98</sup> and limits the rebuttable (so-called *iuris tantum*) ones to the cases in which the rule of experience indicates the likelihood of an abusive practice.<sup>99</sup> Moreover, the exercise of genuine rights may not become more burdensome as an indirect consequence of their proximity to abusive practices, since this would be tantamount to not protecting such rights at all.

Another issue is not just whether the standard of article 7 MLI and article 29 OECD MC is compatible with EU law, but also and especially how tax authorities will act in such a context. This also applies for the “discretionary relief clause” contained in the text of the LoB clause (article 29(6) OECD MC), which may not be interpreted as giving tax authorities absolute powers, including that to subordinate the entitlement to treaty benefits to conditions that are in fact impossible to meet. By contrast, this clause is an instrument for them to also grant the treaty benefits when the tests of the LoB would otherwise fail to do so. Insofar as we interpret the clause in line with the requirements of the rule of law, which play a particularly important role under EU law, tax authorities not only have the power to grant relief under the treaty, but also the obligation to do so.

#### 4.C. Principal Purposes Test (PPT)

The Principal Purposes Test (PPT) under article 7(1) MLI and article 29(9) OECD MC allows tax authorities to reject the entitlement to treaty benefits in the presence of grounds that indicate the existence of an abusive practice, i.e., “if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention”. If the application of this measure is based on an effective rule of experience that indicates the abusive nature of a given practice and allows the taxpayer to prove the contrary, it may in principle fit within the justification admitted by the Court of Justice for admitting the restrictions on the exercise of fundamental freedoms. It has, however, been addressed by the Commission’s 2016 Recommendation<sup>100</sup> and might indeed raise a number of concerns because it arguably deviates from the standard of abuse established under EU law. On the one hand, the application of this measure allows for a certain degree of flexibility, which is compatible with a proportionate reaction to abusive practices and thus may help reducing the overkill effects on the genuine exercise of rights. On the other hand, the PPT takes an

<sup>96</sup> ECJ, 15 January 2002, C-55/00, *Gottardo*, EU:C:2002:16.

<sup>97</sup> ECJ, 5 November 2002, C-466/98 et al., *Commission v. United Kingdom et al.*, EU:C:2002:624.

<sup>98</sup> See ECJ, 18 December 1997, C-286/94, C-340/95, C-401/95 and C-47/96, *Garage Molenheide*, EU:C:1997:623.

<sup>99</sup> See ECJ, 28 October 1999, C-55/98, *Bent Vestergaard*, EU:C:1999:533.

<sup>100</sup> See *supra* ch. 3.

approach that deviates from established EU anti-abuse doctrine: First, the “reasonableness test” is not *per se* a problem if it is understood that it requires the tax authorities to give proper evidence and effectively allows taxpayers to give evidence to the contrary without making the burden of proof too difficult or using unlimited discretionary powers. Second, the standards of tolerance for treaty shopping under the PPT (“one of the principal purposes”) may be in fact lower than the ones established by settled case law of the ECJ (“essential purpose”) to justify restrictions on the exercise of fundamental freedoms for countering abusive practices.

It is, however, not yet clear if those concerns merely relate to policy or if they may amount to a question of EU compatibility with regard to the fundamental freedoms. On the one hand, one might argue the latter for cases where the application of the PPT amounts to a non-discriminatory restriction such as at issue in *Deutsche Shell*<sup>101</sup> or where differences in the application of countering abuse in the domestic and cross-border scenarios lead to a *de facto* discrimination.<sup>102</sup> On the other hand, one might argue that the PPT *per se* can never lead to a relevant restriction: It merely denies a treaty benefit so that taxation is (again) exclusively governed by domestic law, and if such domestic law is non-discriminatory the cross-border situation is not treated worse than a comparable domestic transaction; likewise, even if the denial of treaty benefits would lead to double taxation, this would not infringe upon the freedoms.<sup>103</sup> It will, however, eventually be for the Court to decide that matter if so asked.

## 5. Beyond the MLI: binding dispute resolution

Juridical double taxation “is the most serious obstacle there can be to people and their capital crossing internal borders”.<sup>104</sup> However, outside the limited scope of the company tax directives,<sup>105</sup> EU law neither provides for explicit substantive mechanisms to avoid juridical double taxation of income or capital between member states<sup>106</sup> nor has the ECJ so far found

<sup>101</sup> ECJ, 28 February 2008, C-293/06, *Deutsche Shell*, EU:C:2008:129.

<sup>102</sup> In those situations, proportionality would require a case-by-case analysis that gives the taxpayers a right to prove the genuine nature of their transactions and accordingly protects the exercise of their rights, as granted by EU law.

<sup>103</sup> ECJ, 14 November 2006, C-513/04, *Kerckhaert-Morres*, EU:C:2006:713; see also, e.g., ECJ, 12 February 2009, C-67/08, *Block*, EU:C:2009:92; ECJ, 19 September 2012, C-540/11, *Levy and Sebbag*, EU:C:2012:581, and also EFTA Court, 7 May 2008, E-7/07, *Seabrokers*, para. 49 et seq.

<sup>104</sup> Opinion of Advocate General Colomer, 26 October 2004, C-376/03, D, EU:C:2004:663, para. 85.

<sup>105</sup> Such as the avoidance of juridical double taxation of inter-company dividends under the Parent-Subsidiary Directive (Council Directive 2011/96/EU) and of inter-company interest and royalty payments under the Interest-Royalties-Directive (Council Directive 2003/49/EC). Also, the step-up provided in art 5(5) of the ATAD (Council Directive (EU) 2016/1164) is a measure to avoid – time delayed – double taxation of the same capital gain.

<sup>106</sup> The only provision directly dealing with double taxation was former art. 293(2) of the EC Treaty, which urged the member states, “so far as is necessary, [to] enter into negotiations with each other with a view to securing for the benefit of their nationals ... the abolition of double taxation within the Community”. That provision was not directly applicable to the benefit of taxpayers (ECJ, 12 May 1998, C-336/96, *Gilly*, EU:C:1998:221, para. 15) and was also subject to intense debate with regard to its interpretation. Art. 293 of the EC Treaty was, however, repealed by the Treaty of Lisbon (Point 280, [2007] OJ C 306/1) and speculation as to the reasons for its repeal and its effect are ongoing.



that the fundamental freedoms offer relief.<sup>107</sup> It is nevertheless common ground that the abolition of double taxation is, still,<sup>108</sup> an objective of the TFEU and even a “priority objective” of the Union,<sup>109</sup> as the overlap of taxing jurisdictions may result in distortions of the internal market.<sup>110</sup> In light of the un-harmonized international tax systems of the member states and their competence to conclude bi- and multilateral tax treaties, the Commission’s focus has always been on procedural mechanisms to avoid those distortions: As early as 1976, the Commission had tabled a proposal for a directive regarding an arbitration procedure for the elimination of double taxation resulting from transfer pricing adjustments,<sup>111</sup> but this proposed directive was not adopted by the Council due to member states’ resistance, largely on sovereignty concerns.<sup>112</sup> The member states have, instead, concluded the multilateral 1990 Arbitration Convention,<sup>113</sup> which is based on former article 293 of the EC Treaty (ex-article 220 EEC Treaty). This multilateral convention deals exclusively with the – narrow, but extremely important – issues of transfer pricing and profit attribution and has also been made workable in practice through the guidance developed by the EU’s Joint Transfer Pricing Forum (JTPF).<sup>114</sup> Despite the OECD’s work in that area, especially in the framework of Action 14 of the BEPS project and Part V of the Multilateral Instrument (MLI), there are still many situations where double taxation can persist, even within the European Union.

Accordingly, from an EU perspective, the Commission has long viewed the lack of an overall binding dispute resolution procedure for intra-EU situations as an issue to be addressed for both internal market reasons and global competitiveness.<sup>115</sup> Having announced further work

<sup>107</sup> The Grand Chamber of the ECJ, in its 2006 decision in *Kerckhaert-Morres*, i.e., at a time when (old) art. 293(2) EC Treaty was still part of primary law, declined to hold juridical double taxation to be incompatible with the fundamental freedoms (ECJ, 14 November 2006, C-513/04, *Kerckhaert-Morres*, EU:C:2006:713), and the Court has since confirmed that conclusion at a number of occasions (see, e.g., ECJ, 12 February 2009, C-67/08, *Block*, EU:C:2009:92, ECJ, 19 September 2012, C-540/11, *Levy and Sebbag*, EU:C:2012:581, and also EFTA Court, 7 May 2008, E-7/07, *Seabrokers*, para. 49 et seq.).

<sup>108</sup> See ECJ, 12 September 2017, C-648/15, *Austria v. Germany*, EU:C:2017:664, para. 26, noting “the beneficial effect of the mitigation of double taxation on the functioning of the internal market that the European Union seeks to establish in accordance with Article 3(3) TEU and Article 26 TFEU”. In the past, the ECJ specifically referred to – now repealed – art. 293(2) of the EC Treaty to establish that “the abolition of double taxation is one of the objectives of the Community to be attained by the Member States” (see, e.g., ECJ, 12 May 1998, C-336/96, *Gilly*, EU:C:1998:221, para. 16, and ECJ, 19 January 2006, C-265/04, *Bouanich*, EU:C:2006:51, para. 49).

<sup>109</sup> See, e.g., “Taxation in the Single Market”, Periodical 6/1990, 25.

<sup>110</sup> Discussion paper for the Informal Meeting of Economic and Financial Affairs Council (ECOFIN) Ministers, Taxation in the European Union, SEC(96)487 final, 7 (20 March 1996).

<sup>111</sup> Proposal for a Council Directive on the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises (arbitration procedure), COM (76) 611 final (25 November 1976) = [1976] O J C 301/4.

<sup>112</sup> The proposal was eventually withdrawn two decades later; see [1997] O J C 2/6.

<sup>113</sup> Convention 90/463/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, [1990] O J L 225/10, as amended.

<sup>114</sup> For a detailed overview on the Convention and the JTPF’s work see, e.g., G. Kofler, “Tax Disputes and the EU Arbitration Convention”, in: E. Baistrocchi (ed.), *Resolving Tax Treaty Disputes: A Global Analysis*, Cambridge University Press 2017, 205–236.

<sup>115</sup> The following brief analysis is largely based on G. Kofler, “EU Tax Dispute Resolution Directive: The Deathblow to Double Taxation in the European Union”, 28 *EC Tax Review* (2019), p. 266–269.



in this area in the early 2010s,<sup>116</sup> the Commission made a proposal for a directive on dispute resolution in 2016,<sup>117</sup> which was swiftly adopted by the Council.<sup>118</sup> This directive provides a binding procedural mechanism for resolving disputes between member states regarding EU resident taxpayers (article 2(1)(d)) when those disputes arise from the interpretation and application of agreements and conventions (i.e., tax treaties between member states and the EU Arbitration Convention) that provide for the elimination of double taxation of income and, where applicable, capital;<sup>119</sup> it hence does not apply to double taxation created by the interaction of domestic laws (e.g., the implementation of the ATAD), if the dispute is not based on the “interpretation and application” of a tax treaty. The directive had to be implemented by member states by 30 June 2019 and it “shall apply to any complaint submitted from 1 July 2019 onwards relating to questions of dispute relating to income or capital earned in a tax year commencing on or after 1 January 2018”.

The directive contains strict timelines and detailed rules for initiating the procedure (article 3), for the MAP and for arbitration (articles 4 to 14), the composition of the arbitration panels (articles 8, 9 and 10), details on the rules of functioning, the costs and the procedure regarding evidence etc (article 11, 12 and 13),<sup>120</sup> the opinion of the arbitration panel (article 15), a number of taxpayer safeguards to keep the process moving,<sup>121</sup> exclusions (e.g., for cases of penalties regarding tax fraud under article 16(6)), rules regarding the interaction with national proceedings and dispute resolution under tax treaties (article 16) and simplifications for individuals and small undertakings (article 17); the final decision rests with the competent authorities (which can deviate from the arbitration panel’s opinion), but “if they fail to reach an agreement as to how to resolve the question in dispute, they shall be bound by that opinion” (article 15). Moreover, a resolution requires that the taxpayer agrees and renounces the right to any other remedy or terminates any action, and in that case the decision must be implemented “irrespective of any time limits prescribed by the national law” (articles 4(2), 15(4)).

<sup>116</sup> See, e.g., the Commission’s Communication on “Double Taxation in the Single Market”, COM(2011) 712 final (11 November 2011), at p. 11, where it is stated that the “Commission sees a need to analyse the improvements that can be made to the procedures for the resolution of double taxation disputes within the EU. In particular, the possibility of a mechanism to effectively and swiftly resolve these disputes in all areas of direct taxation should be explored”.

<sup>117</sup> Proposal for a Council Directive on Double Taxation Dispute Resolution Mechanisms in the European Union, COM(2016)686 (25 October 2016).

<sup>118</sup> Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union, [2017] OJ L 265/1.

<sup>119</sup> See, e.g., the comprehensive analysis by H. M. Pit, *Dispute Resolution in the EU* (IBFD 2018). For a comparison between the OECD and the EU approaches see S. Govind, “The New Face of International Tax Dispute Resolution: Comparing the OECD Multilateral Instrument with the EU Dispute Resolution Directive”, 27 *EC Tax Review* (2018), 309–324.

<sup>120</sup> The Commission has issued standard rules of functioning for the Advisory Commission and the Alternative Dispute Resolution Commission in case the competent authorities either have not agreed upon such rules or only done so incompletely. See Commission Implementing Regulation (EU) 2019/652 of 24 April 2019 laying down standard Rules of Functioning for the Advisory Commission or Alternative Dispute Resolution Commission and a standard form for the communication of information concerning publicity of the final decision in accordance with Council Directive (EU) 2017/1852, [2019] OJ L 110/26. For an overview see also, e.g., K. Perrou, “Taxpayer Rights and Taxpayer Participation in Procedures Under the Dispute Resolution Directive”, 47 *Intertax* (2019), p. 715–724.

<sup>121</sup> The directive contains taxpayer safeguards throughout the procedure, e.g., recourse to the Advisory Commission where not all member states involved accept a complaint (art. 6) or appointment by competent courts or a national appointing body should the competent authorities not set up an arbitration panel in time (art. 7).

The directive's substance scope covers "disputes between member states when those disputes arise from the interpretation and application of agreements and conventions that provide for the elimination of double taxation of income and, where applicable, capital".<sup>122</sup> It hence requires the existence of a tax treaty (or the Arbitration Convention) between the member states. This is, however, not a high hurdle: Out of the 378 possible bilateral tax treaty relationships between the (current) 28 member states, only five are not covered by a tax treaty.<sup>123</sup> Moreover, and unlike the Commission proposal,<sup>124</sup> the directive applies to all kinds of income tax disputes, whether business or individual. However, the directive only addresses income and capital taxation, but neither extends to inheritance and gift taxation or double taxation with other taxes (e.g., car registration taxes, consumption taxes etc),<sup>125</sup> i.e., areas where few tax treaties exist. However, it is a significant progress as compared with bilateral mechanisms given the fact that the directive clearly covers disputes in situations involving three or more member states, a typical "risk area" for unrelieved double taxation.<sup>126</sup>

The directive covers "disputes" between member states that arise "from the interpretation and application" of tax treaties or of the Arbitration Convention. Those disputes certainly cover cases of "double taxation" within the meaning of article 2(1)(c) of the TDRD but are not limited to those. Rather, the directive extends to disputes beyond issues of double taxation, e.g., with regard to the application of non-discrimination provisions. However, the directive deviates from article 25 OECD MA in that its article 2(1)(c) specifically defines "double taxation" as "the imposition by two or more Member States of taxes covered by an agreement or convention referred to in article 1 in respect of the same taxable income or capital when it gives rise to either: (i) an additional tax charge; (ii) an increase in tax liabilities; or (iii) the cancellation or reduction of losses that could be used to offset taxable profits". What seems hence not to be included in the directive's notion of "double taxation" are situations of so-called "virtual double taxation", where a tax treaty would, in principle, require exemption even if the other state does not tax the income (e.g., because of an exemption under domestic law or an unresolved

<sup>122</sup> This is broader and at the same time narrower than the Commission's proposal: The proposal would have applied "to all taxpayers that are subject to one of the taxes on income from business listed in Annex I" – i.e., the Member States' income and corporate taxes –, "including permanent establishments situated in one or more Member State whose head office is either in a Member State or in a jurisdiction outside the Union", i.e., irrespective of the existence of a double taxation convention between the member states (making, instead, "international practice in matters of taxation such as the latest OECD Model Tax Convention" the yardstick for arbitration).

<sup>123</sup> As of January 2020, those are the relations between Cyprus and Croatia (the 1985 treaty was terminated); Cyprus and the Netherlands (with a treaty initialled in September 2019); Denmark and France (the 1957 treaty was terminated effective January 1, 2009, and a new treaty is currently under negotiation); Denmark and Spain (the 1972 treaty was terminated effective 1 January 2009); and Finland and Portugal (the 1970 treaty was terminated effective 1 January 2019, and the 2016 treaty is not yet in force).

<sup>124</sup> The Commission's proposal with its limitation to "income from business" raised criticism from the European Parliament which (quite correctly) pointed out that the impact of "[d]isputes on the taxation of income, such as pensions and salaries" on individuals "can be significant". See Amendment 16 of the European Parliament legislative resolution of 6 July 2017 on the proposal for a Council directive on Double Taxation Dispute Resolution Mechanisms in the European Union (P8\_TA(2017)0314), [2018] OJ C 334/266.

<sup>125</sup> There is hence ample room for expansion as to the taxes covered by the EU dispute resolution mechanism. See, e.g., the Commission's Communication on "Tackling cross-border inheritance tax obstacles within the EU", COM(2011) 864 final (15 December 2011), and the Report of Commission's expert group on "Ways to tackle inheritance cross-border tax obstacles facing individuals within the EU" (December 2015).

<sup>126</sup> See, e.g., art 2(1)(c), speaking of the imposition of taxes "by two or more Member States", and similar language throughout the Directive.

negative conflict of qualification).<sup>127</sup> Conversely, situations of conflicts of qualification, where, e.g., “one Member State interprets a source of income as salary while the other Member State interprets the same source of income as profit”, would be covered by that definition,<sup>128</sup> and relevant “double taxation” arguably also exists where member states tax the same income but in different taxable years. Likewise, classical economic double taxation in transfer pricing and profit attribution cases (i.e., the object also of the EU Arbitration Convention) seems to fall squarely within the directive’s notion of “double taxation”, as it does not require that double taxation occurs in the hands of the same taxpayer. That said, the distinction of whether a “dispute” involves “double taxation” is relevant: This is because, under article 16(7), a member state may “deny access to the dispute resolution procedure under Article 6 on a case-by-case basis where a question in dispute does not involve double taxation”.<sup>129</sup> However, that case-by-case exclusion is limited to the arbitration procedure, whereas access to the directive’s mutual agreement procedure remains available for all relevant “disputes”.

In line with the concept of the Arbitration Convention, the primary tool for dispute resolution after a failed Mutual Agreement Proceeding is arbitration by a so-called “Advisory Commission”. As said above, the directive provides a detailed set of rules on procedure, timing, appointments, information, evidence, hearings, costs etc (and the Commission has further drafted standard rules of functioning<sup>130</sup>), and – in article 15 – also determines that the Advisory Commission has to issue a – reasoned – independent “opinion” in writing (which may or may not be accepted by the competent authorities)<sup>131</sup>. This opinion is to be based “on the provisions of the applicable agreement or convention [...] as well as on any applicable national rules”. While an independent opinion might certainly have its benefits, a recent international trend is to agree on the so-called “final offer”, “last best offer” or “baseball” arbitration,<sup>132</sup> where the arbitration panel (only) has to decide between competing proposals made by the competent authorities (e.g., a specific monetary amount of income or expense). This implicitly forces the competent authorities to take reasonable and well-considered positions in their submissions, while also barring the arbitration panel from simply “splitting the difference”.<sup>133</sup> That said,

<sup>127</sup> For a detailed analysis of this definition of double taxation and further nuances see R. Ismer, “Was ist internationale Doppelbesteuerung?”, in: R. Ismer, E. Reimer, A. Rust and Ch. Walhoff (eds.), *Territorialität und Personalität, Festschrift für Moris Lehner*, Otto Schmidt 2019, 27-46.

<sup>128</sup> The European Parliament refers to that situation as “economic double taxation”. See Amendment 16 of the European Parliament legislative resolution of 6 July 2017 on the proposal for a Council directive on Double Taxation Dispute Resolution Mechanisms in the European Union (P8\_TA(2017)0314), [2018] OJ C 334/266.

<sup>129</sup> See for that compromise of keeping a (broader) scope of the directive and permitting member states to deny access to the dispute resolution procedure on a case-by-case bases paras 8-10 in Doc. 9011/17 FISC 99 ECOFIN 345 (12 May 2017).

<sup>130</sup> See Commission Implementing Regulation (EU) 2019/652, [2019] OJ L 110/26.

<sup>131</sup> Under art. 15, it is for the competent authorities to agree on how to resolve the question in dispute within six months after the opinion. The competent authorities may take a decision which deviates from the opinion of the Advisory Commission or Alternative Dispute Resolution Commission. However, if they fail to reach an agreement as to how to resolve the question in dispute, they shall be bound by that opinion.

<sup>132</sup> It should be noted, e.g., that under Part V of the OECD’s Multilateral Instrument (MLI) as of December 2019, 22 out of the currently 30 States opting for mandatory binding arbitration have chosen “baseball arbitration” (these are Australia, Austria, Barbados, Belgium, Canada, Curacao, Denmark, Fiji, Finland, France, Germany, Ireland, Italy, Liechtenstein, Luxembourg, Mauritius, Netherlands, New Zealand, Singapore, Spain, Switzerland and the UK, whereas Andorra, Greece, Japan, Malta, Papa New Guinea, Portugal, Slovenia, and Sweden have opted out of baseball arbitration).

<sup>133</sup> For a brief analysis see, e.g., N. Bravo, “Mandatory Binding Arbitration in the BEPS Multilateral Instrument”, Nathalie Bravo”, 47 *Intertax* (2019), p. 693, at p. 698-699.

the directive gives member states a tool to opt for “baseball arbitration” in that it foresees, in article 10, the setting up of an “Alternative Dispute Resolution Commission” (ADRC) to resolve the dispute instead of an Advisory Commission. Indeed, the ADRC may apply “any dispute resolution process or technique”, “including the ‘final offer’ arbitration process (otherwise known as ‘last best offer’ arbitration)”, hence enabling the choice of a streamlined process. Also, “baseball arbitration” does not necessarily mean that the arbitration panel must be prevented from giving reasons for the decision, although article 23(1)(c) of the OECD’s MLI takes the clear position that the arbitration panel’s decision “shall not include a rationale or any other explanation of the decision”; in contrast, the directive would certainly allow for “baseball arbitration with reasons”.<sup>134</sup> Moreover, the ADRC is not limited to ad hoc arbitration, but can also have a permanent nature (a so-called “Standing Committee”), which could be a real chance for a permanent arbitration structure<sup>135</sup> or even serve as a first step towards the establishment of a European tax court.<sup>136</sup>

In summary, the TDRD certainly has a number of shortcomings and raises questions as to taxpayer’s fundamental rights,<sup>137</sup> but it nevertheless is a welcome and potentially huge step to prevent persisting double taxation in the European Union and might even open further avenues for the establishment of a permanent arbitration structure.<sup>138</sup> Moreover, and even if some technicalities might need to be worked out in practice, the mere existence of a legally enforceable, tightly timed arbitration mechanism will certainly have a positive impact on the member states’ willingness to speedily resolve double taxation issues in mutual agreement proceedings before cases are taken out of their hands and into independent arbitration.

## 6. Treaties, non-taxation and state aid?

A further crucial question from an EU law perspective concerns whether double non-taxation amounts to illegal state aid under article 107 TFEU.<sup>139</sup> It is clear that any exemption from taxation normally imposed by a taxpayer’s residence state amounts to a relevant “advantage”

<sup>134</sup> See, however, J. F. Avery Jones, “Types of Arbitration Procedure”, 47 *Intertax* (2019), p. 674, at p. 675, who considers “baseball arbitration with reasons” as “the best of both worlds”.

<sup>135</sup> See, e.g., the discussion in para. 14-17 in Doc. 9011/17 FISC 99 ECOFIN 345 (12 May 2017), and the ideas on a permanent structure developed by S. Piotrowski, R. Ismer, P. Baker, J. Monsenego, K. Perrou, R. Petrucci, E. Reimer, F. Serrano Antón, L. Stankiewicz, E. Traversa and J. Voje, “Towards a Standing Committee Pursuant to Article 10 of the EU Tax Dispute Resolution Directive: A Proposal for Implementation”, 47 *Intertax* (2019), p. 678-692.

<sup>136</sup> See J. Voje, “EU Tax Dispute Resolution Directive (2017/1852): Paving the Path Toward a European Tax Court?”, 58 *European Taxation* (2018), p. 309-317.

<sup>137</sup> See, e.g., K. Perrou, “Taxpayer Rights and Taxpayer Participation in Procedures Under the Dispute Resolution Directive”, 47 *Intertax* (2019), p. 715-724.

<sup>138</sup> It might be noted in passing, however, that the compatibility of the dispute resolution mechanism under the TDRD with arts. 18, 267 and 344 TFEU in light of the ECJ’s judgment in *Achmea* (ECJ, 6 March 2018, C-284/16, *Achmea*, EU:C:2018:158) has been questioned. See for that discussion, e.g., S. Piotrowski, R. Ismer, P. Baker, J. Monsenego, K. Perrou, R. Petrucci, E. Reimer, F. Serrano Antón, L. Stankiewicz, E. Traversa and J. Voje, “Towards a Standing Committee Pursuant to Article 10 of the EU Tax Dispute Resolution Directive: A Proposal for Implementation”, 47 *Intertax* (2019), p. 678, at p. 682-684; J. Monsenego, “Does the *Achmea* Case Prevent the Resolution of Tax Treaty Disputes through Arbitration?”, 47 *Intertax* (2019), p. 725, at p. 733-735; K. Perrou, “Taxpayer Rights and Taxpayer Participation in Procedures Under the Dispute Resolution Directive”, 47 *Intertax* (2019), p. 715, at p. 719-723.

<sup>139</sup> For extensive analysis see C. Marchgraber, *Double (Non-)Taxation and EU Law* (Kluwer, 2017).

for the taxpayer who receives it, irrespective of whether it is granted unilaterally or by way of a bilateral tax treaty. What is less clear, however, is under which circumstances such an advantage will be considered “selective” and, thus, *prima facie* illegal.

The EU Commission has in the past considered “provisions to prevent double taxation” to be of a “purely technical nature” and thus not constitute state aid where “they apply without distinction to all firms and to the production of all goods”.<sup>140</sup> In contrast to this fairly broad exception, it noted in its 2016 explanatory notice merely that “the need to avoid double taxation” would be “the basis for a possible justification”.<sup>141</sup> While this still seems to protect member states’ freedom to provide relief from double taxation<sup>142</sup> and, indeed, to choose different methods for doing so in different tax treaties,<sup>143</sup> it is not clear that this remains true in cases where a particular relief mechanism leads to “overcompensation” that expresses itself as non-taxation, such as in the case of exemption granted for untaxed foreign income.<sup>144</sup>

In the *McDonald’s* case,<sup>145</sup> the EU Commission initially considered that the exemption in Luxembourg of profits attributed – at least under domestic law<sup>146</sup> – to a permanent establishment in the US would amount to state aid if the US did not tax those profits. It ultimately reversed course, however, and concluded that the applicable tax treaty – interpreted in line with guidance from the OECD Commentaries – did not require taxation in the source state as a precondition for the obligation on the residence state to exempt income

<sup>140</sup> See para. 13 of the Commission’s notice on the application of the state aid rules to measures relating to direct business taxation, [1998] OJ C 384, p. 3.

<sup>141</sup> See para. 139 of the Commission’s notice on the notion of state aid as referred to in art. 107(1) of the Treaty on the Functioning of the European Union, [2016] OJ C 262, p. 1.

<sup>142</sup> See, e.g., W. Schön, “Taxation and State Aid Law in the European Union”, 36 *Common Market Law Review* (1999), p. 911, at p. 935; W. Schön, “State Aid in the Area of Taxation”, in: L. Hancher, T. Ottervanger & P.J. Slot (eds.), *EU State Aids*, 3<sup>rd</sup> edition (Sweet & Maxwell, 2016), p. 393, at p. 426 (noting that “[t]ax provisions which are advantageous to foreign or domestic investors engaged in cross-border activities are not at all ‘aids’ insofar as they only strive to reduce or compensate for the disadvantageous effects of double taxation”).

<sup>143</sup> See, e.g., R. Luja, “Tax Treaties and State Aid: Some Thoughts”, 44 *European Taxation* (2004), p. 234 et seq.

<sup>144</sup> See on this discussion, e.g., C. HJI Panayi, “Limitation on Benefits and State Aid”, 44 *European Taxation* (2004), p. 83 et seq.; R. Luja, “Tax Treaties and State Aid: Some Thoughts”, 44 *European Taxation* (2004), p. 234 et seq.; F. Ph. Sutter, “Die DBA-Freistellungsmethode als unzulässige Beihilfe i. S. d. Art. 87 EG?”, 14 *Steuer und Wirtschaft International* (2004), p. 4 et seq.; C. HJI Panayi, *Double Taxation, Tax Treaties, Treaty-Shopping and the European Community* (Kluwer, 2007), p. 169 et seq.; S. Leitsch, “Stellt die fiktive Quellensteueranrechnung gemäß DBA eine unzulässige Beihilfe dar?”, 28 *Steuer und Wirtschaft International* (2018), p. 217 et seq. For a broad perspective based on the recent OECD BEPS discussion see P. Rossi-Maccanico, “Fiscal Aid, Tax Competition, and BEPS”, 75 *Tax Notes International* (Sept. 8, 2014), p. 857, at p. 865-866, and P. Rossi-Maccanico, “Fiscal State Aids, Tax Base Erosion and Profit Shifting”, 24 *EC Tax Review* (2015), p. 63 et seq.

<sup>145</sup> Case SA.38945 on possible aid granted by Luxembourg to McDonald’s Europe: [2016] OJ C 258, p. 11 (‘McDonald’s Opening Decision’) and [2019] OJ L 195, p. 20 (‘McDonald’s Final Decision’).

<sup>146</sup> It was unclear from the Opening Decision whether the attribution to such permanent establishment was in line with the proper reading of the terms of the applicable double tax convention, since it remained uncertain whether there was such an establishment from the US perspective; ultimately, the Commission concluded that the attribution under Luxembourg’s domestic law was decisive by virtue of art. 3(2) of the double tax convention (see paras 112-113 of the McDonald’s Final Decision).

properly allocated to the former.<sup>147</sup> Notably, to show selectivity, the Commission attempted merely to prove that Luxembourg had misapplied the applicable tax treaty.<sup>148</sup> It did not rely on the alternative argument that double non-taxation resulting from the application of a tax treaty *ipso facto* amounts to state aid.

So, at this point in time, the Commission seems to identify each individual tax treaty as the appropriate reference framework to establish “normal taxation”, instead of either national corporation tax system in its entirety. Consequently, only selective misapplication of a tax treaty to give a taxpayer benefits that are not due under the proper interpretation, will be recognized as state aid. Notably, the Commission is likely to consider any interpretation that deviates from the treaty-related OECD Commentaries to be erroneous and thus aid. However, if the Commission chose the reference framework differently – and it almost certainly could do so as this choice is not pre-determined<sup>149</sup> – the benefits granted by a tax treaty could be directly scrutinized as *prima facie* aid with the consequence that “double taxation relief” would have to be relegated to an issue of justification and thus – crucially – be subject to a proportionality analysis.<sup>150</sup> Under this alternative approach, one might even go as far as questioning treaty benefits that result in “white income” because they are not made dependent on the other contracting state domestically exercising the taxing right assigned to it through a subject-to-tax clause.<sup>151</sup> Exempting income that would not otherwise be at risk of double taxation is not “necessary” to avoid double taxation, nor is it possible to characterize a system that freely grants such benefit as implementing the least far-reaching measures to achieve that goal. Such inquiry would, however, be at odds with the accepted principle of capital import neutrality.<sup>152</sup>

As the Commission appears to be motivated partly by a desire neither to upset the balanced allocation of taxing rights resulting from a tax treaty nor the perceived “international standard” visible in the OECD Commentaries, the distinction between the approaches outlined above is likely to become less pronounced following the implementation of the new post-BEPS standard through the MLI. As the latter makes it clear that existing tax treaties do

<sup>147</sup> Specifically, the Commission accepted that the non-taxation outcome was not the result of a conflict of qualification and thus not subject to the corresponding solution suggested in the OECD Commentaries. See for details on the proceedings and arguments, e.g., R. Szudoczky, “Double Taxation Relief, Transfer Pricing Adjustments and State Aid Law: Comments”, in: I. Richelle, W. Schön & E. Traversa (eds.), *State Aid Law and Business Taxation* (Springer, 2013), p. 163, at p. 171-173; O. R. Hoor & K. O'Donnell, “McDonald's State Aid Investigation: What the European Commission Got Wrong”, 83 *Tax Notes International* (Sept. 12, 2016), p. 975 et seq.; F. Shaheen, “Tax Treaty Aspects of the McDonald's State Aid Investigation”, 86 *Tax Notes International* (Apr. 24, 2017), p. 331 et seq.; B. Larking, “How Did McDonald's Get Off the EU State Aid Hook?”, 93 *Tax Notes International* (Feb. 4, 2019), p. 479 et seq.

<sup>148</sup> See McDonald's Final Decision, paras 107-109.

<sup>149</sup> W. Haslehner, “Double Taxation Relief, Transfer Pricing Adjustments and State Aid Law”, in: I. Richelle, W. Schön & E. Traversa (eds.), *Allocating Taxing Powers within the European Union* (Springer, 2013), p. 133, at p. 138-143.

<sup>150</sup> See para. 140 of the Commission's notice on the notion of state aid as referred to in art. 107(1) of the Treaty on the Functioning of the European Union, [2016] OJ C 262, p. 1, referring to the ECJ, 8 September 2011, C-78/08 to C-80/08, *Paint Graphos and others*, ECLI:EU:C:2011:550, para. 75.

<sup>151</sup> See, with further references, W. Haslehner, “Double Taxation Relief, Transfer Pricing Adjustments and State Aid Law”, in: I. Richelle, W. Schön & E. Traversa (eds.), *Allocating Taxing Powers within the European Union* (Springer, 2013), p. 133, at p. 135-143; R. Szudoczky, “Double Taxation Relief, Transfer Pricing Adjustments and State Aid Law: Comments”, in: I. Richelle, W. Schön & E. Traversa (eds.), *State Aid Law and Business Taxation* (Springer, 2013), p. 163, at p. 169-179.

<sup>152</sup> See in the area of the fundamental freedoms, e.g., ECJ, 12 December 2002, C-385/00, *De Groot*, EU:C:2002:750; ECJ, 28 February 2013, C-168/11, *Beker and Beker*, EU:C:2013:117).

not intend to create opportunities for non-taxation,<sup>153</sup> the Commission would be somewhat<sup>154</sup> strengthened in scrutinizing a double non-taxation outcome derived from a misapplication of the relevant tax treaty.

EU state aid rules do not by themselves rule out member states concluding or maintaining tax treaties that allow double non-taxation to occur; however, it is undoubtedly the case that such outcomes will be scrutinized even more closely going forward.

<sup>153</sup> Art. 6 MLI.

<sup>154</sup> The argument must be limited by the fact that the preamble text included via art. 6 MLI is not the equivalent of adding a subject-to-tax clause into the tax treaty; therefore, the limits of interpretation must be heeded.





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