Tax Treaties and EC Law
Development, Problems and Solutions

Master’s thesis within EC Law and International Tax Law

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Abstract

Double taxation treaties play a vital part in the international relations between states regarding taxation matters. Since double taxation can occur as soon as a person has income in more than one state, it is very important that there can be effective remedies to the problems that can occur in these situations. Double taxation treaties are necessary in most situations created by international trade and they are even more important in such a free flowing economic co-operation such as the EU, where the trade between the Member States is not only free but also very frequent.

Most double taxation treaties are based on the Model Treaty created by the OECD. Even states not members of the organization use it as a model for their treaties. This means that treaties between Member States of the EC are often rather similar, but many times have been drafted without consideration taken to EC law. This can create problems since the European Court of Justice (ECJ) has stated in its case law that even though the Member States are solely competent when it comes to direct taxation, that competence must be used in accordance with EC law. Since double taxation treaties are directed at flows of income and capital between states, it is most probable that they can run afoul of EC law.

After some judgments of the ECJ the situation is clearer now, but there are still some possible future problems. Examples of such problems are trailing taxes, limitations of benefits and the most favoured nation (MFN) principle. The latter has been before the Court, but there are many questions surrounding the MFN principle that has not been answered satisfactorily. Even if more cases are brought before the Court and it gives more guidance on how the Member States shall conclude treaties with each other, it is still preferable with proper EC legislation on the subject. It must also be mentioned that the ECJ has shown reluctance to disrupting the tax treaty networks in place and has been reluctant to dismiss rules based on the OECD Model Treaty.

Several different solutions to these problems have been put forward, ranging from doing almost nothing and just letting the development in the case law have its way to a complete regulation of these issues through legislation by the EC. The two most interesting solutions presented are a Multilateral EU Tax Treaty or an EU Model Tax Treaty. Both of these two different methods would mean that the problems would have a proper solution in that it would implement common rules that would be applicable over the whole of the EU.
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### Abbreviations

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<tr>
<td>AG</td>
<td>Advocate General</td>
</tr>
<tr>
<td>CFC</td>
<td>Controlled Foreign Corporation</td>
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<td>EC</td>
<td>European Community</td>
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<td>ECJ</td>
<td>European Court of Justice</td>
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<td>EU</td>
<td>European Union</td>
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<tr>
<td>MFN</td>
<td>Most-Favoured-Nation</td>
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<tr>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
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<tr>
<td>PE</td>
<td>Permanent Establishment</td>
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1 Introduction

1.1 Background
One of the major problems faced in international taxation is that of double taxation. Double taxation arises when the same asset, financial transaction or income is taxed twice or more due to different states’ overlapping tax jurisdictions and conflicting tax laws. A prime example is a taxpayer who lives in one state but works in another. The residence state will typically want to tax its resident on his or her worldwide income, while the source state in turn will want to tax the income that is derived from working within its territory. The taxpayer will be caught in between and be unfairly burdened by double taxation. To prevent this from occurring, states primarily use the method of negotiating and signing treaties for the avoidance of double taxation. Almost all of these treaties are bilateral, i.e. between two states, although there have been some ventures into concluding multilateral treaties. The Organization for Economic Co-operation and Development (the OECD) plays a vital role in the field of double taxation, as its Model Tax Convention on Income and Capital\(^1\) is the basis of most tax treaties concluded between states.

A fundamental aspect of the European Community is that the Member States who have entered into it by signing the EC Treaty\(^2\) have themselves voluntarily limited the scope of their sovereignty in favor of the Community, in certain areas. The Member States are therefore bound, when exercising their legislative powers, to comply with certain Community principles. Perhaps foremost among these principles are the concepts of non-discrimination and the fundamental freedoms (the freedom of movement for goods, persons, services, and capital).

The EC Treaty does not contain any provisions directly related to direct taxation, which means that the Member States have retained the sovereign rights to decide on such matters. It was thought that the area of direct taxation was completely separate from the rules of the EC Treaty, but this was never really true. When asked if the EC Treaty limited the rights of Member States to decide on their own rules of taxation, the ECJ has given a famous statement\(^3\), making it clear that even though the Member States are solely competent in the field of direct taxation, any such competence must be exercised in accordance with EC law. Since this statement was first issued, many cases on direct taxation have been put before the Court, and many of the Member States have been forced to change their tax legislation. The preliminary rulings that the Court has had to give have been in relation to such disparate subjects as Controlled Foreign Companies (CFC) and the taxation of income from pension schemes. The main reasons for finding that direct taxation is connected to EC law is that direct taxation can be a deterrent for persons trying to use their right to free movement, and as such be in direct conflict with the aims of the community to create an inner market.

In the late 1990s the Court ruled that double taxation treaties are also within the Community sphere. There is not a lot of case law on the subject, but the case law there is has shed

\(^1\) OECD, Model Tax Convention on Income and Capital, 2005.
\(^2\) Treaty establishing the European Communities, C/325 of 24 December 2002.
\(^3\) See e.g. case C-264/96 Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes) [1998] ECR I-4695, para. 19.
light on many areas of double taxation treaties that will be in risk of being contrary to EC law. Among the problems that have been discussed by the Court are the methods used to avoid double taxation, the treatment of permanent establishments and the problems related to most-favoured-nation treatment.

Because of the fact that any decisions by the EC with regard to direct taxation must be unanimous, the development of Community acts on this subject has been clearly hampered. The development of Community rules has therefore been forced upon the Court which has on a number of occasions done the job of interpreting the treaties’ rules with regard to double taxation. Almost all the EC rules regarding direct taxation in any way are derived from the case law of the ECJ.

The question if EC law prescribes the use of the most-favoured-nation (MFN) principle for tax treaties between Member States is perhaps the issue that could have the farthest reaching consequences for the tax treaty network within the EU, among the problems that have surfaced in relation to EC law and tax treaties in the last few years. The concept of MFN is primarily used in international trade agreements. Basically, when one state awards another state MFN status, that latter state must then be granted the same advantages, by the first state, as those that are granted to any other third state (within the boundaries of the subject matter of the agreement). As regards MFN as it applies to EC law and tax treaties, the questions raised concern if the refusal to give tax advantages, supplied by provisions of a tax treaty, to taxpayers not residing in the contracting Member State is precluded by the Community principles of non-discrimination and the freedom of movement. If those questions are answered in the affirmative, it could possibly mean that residents of any Member State, in situations involving taxation in another Member State, would have the right to rely on provisions supplied for by any tax treaty concluded by that latter State; effectively removing the option for Member States to have several different tax treaties concluded with different Member States.

As the problems brought on by the conflict between EC law and tax treaties became apparent, solutions have been presented in the literature. Some of the more interesting options among these proposed solutions, and perhaps the ones that are best suited to fulfill the necessary objectives, are the drafting of an EU Model Tax Treaty and the conclusion of a Multilateral EU Tax Treaty.

1.2 Purpose

This thesis will investigate the relationship between tax treaty law and EC law, focusing on the conflicts that arise between the two. Special regard shall be taken to the problem of most-favoured-nation treatment within the Union and the multilateralization issues that could follow should it be accepted by the European Court of Justice. The purpose of this thesis is to ascertain the proper course of action for the future, primarily by debating the advantages and disadvantages of two different methods: a Multilateral EU Tax Treaty that would replace the existing bilateral tax treaties between Member States, and an EU Model Tax Treaty based upon the OECD Model.

1.3 Method

As always when investigating EC law, the EC Treaty is the starting point. The lack of “hard legislation” means current EC law is ascertained by interpreting Community acts through case law and literature on the subject.
Information on the areas related to the conflict between tax treaties and EC law, that could prove to be problematic in the future, has primarily been gathered from legal literature, especially articles published in journals on tax law and other fields of law. The same sources have been used for the proposed solutions to the problems.

When dealing with double taxation treaties, the OECD Model Treaty has been used as a comparison and a common denominator.

1.4 Delimitations

Because of the wealth of case law from the ECJ that could be used in this thesis, some cases will only be mentioned briefly. Therefore, cases not directly connected to tax treaties will not be described in detail. Instead, focus will be on the important principles that arose from those cases.

There is a large amount of potential conflicts caused by the clash between tax treaties and EC law. It would be outside the scope of this thesis to investigate all of these conflicts. Therefore, the problems presented are chosen to highlight certain problematic areas and possible future conflicts.

This thesis focuses specifically on the problems related to tax treaties between EU Member States. As such, tax treaties between Member States and third states, not a part of the EU, will not be dealt with.

As regards the proposed solutions of a Multilateral EU Tax Treaty and an EU Model Tax Treaty, the purpose is to investigate which solution would be most suitable to address the relevant problems, not to comment on the design of individual provisions in any such documents, at least not to any higher degree. However, the relevant sections of the thesis contain references to drafts made by other writers, on both of the proposed solutions.

The aim of this thesis is not to present the different views the Member States have expressed in the commentary to the OECD Model Treaty, therefore any comparison between the opinions of Member States will not be done in great detail.

1.5 Disposition

Chapter 2 deals with the development of EC law. At first the development of the general principles concerning direct taxation in the case law of the ECJ is briefly presented, followed by a listing of the relevant directives in the area. Lastly there is a more detailed account of the cases which specifically deals with tax treaties. At the end of the chapter the reader should have an understanding of the law as it stands today.

Chapter 3 deals with problems created by the conflict between EC law and tax treaty law, primarily when provisions in tax treaties concluded between Member States collide with the EC law rules on non-discrimination and free movement. After first investigating some general problems, the latter part of the chapter will be dedicated to the subject of the MFN-principle, with some final observations on the political and economic aspects of the problematic areas.

Chapter 4 serves to offer the authors’ views on what the future may hold for the relationship between EC law and tax treaty law. The political climate within the union is discussed,
as well as different methods of solving the problems encountered. Two methods are discussed in greater detail: a Multilateral EU Tax Treaty and an EU Model Tax Treaty.

Finally, chapter 5 is the analysis, where the findings of the thesis will be compiled and taken into context, together with the authors’ opinions on the subject.
2 Development

2.1 Introduction

The relation between direct tax law, tax treaty law, and EC law is something that has evolved over the years. As opposed to indirect taxes, which to a large extent have been harmonized within the EU, direct taxes were for a long time thought to fall outside the scope of Community competence. Member States believed themselves to have exclusive competence to legislate on the matter, since direct taxes were not one of the areas in which they had limited their sovereign powers. However, rulings from the ECJ changed the situation. The field of direct tax law and its relationship to EC law has gone a long way since the initial cases, and today there are Community directives on matters of direct taxation in cross-border situations.

This chapter deals with the development of the relationship between direct tax law, tax treaty law and Community law, as interpreted by the ECJ in its case law. Firstly, some key cases in the field of direct tax law will be looked at briefly. These cases are not necessarily directly connected to tax treaties, which is why the focus will be on the principles that have emerged in their wake, and descriptions of the factual circumstances will be kept to a minimum. The next section of the chapter will deal with the few Community directives that exist in the field of direct taxes. In the last, more extensive part of the chapter, focus will shift to the case law of the Court concerning tax treaties.

As the chapter concludes, the aim is that the important principles that have emerged in this development will have been described in a clear and concise manner, and that the reader will have greater understanding for the way in which the ECJ approaches these kinds of cases.

2.2 Case law on direct taxes and EC law

2.2.1 The competence of the ECJ

First of all it is important to address the issue of whether EC law has any bearing on matters of direct taxation. A famous statement by the ECJ, often repeated in tax law cases, concern this very issue: the applicability of Community law and the competence of the Court in matters of income taxation. In this instance the quote is taken from the ICI\(^5\) case, but variations of the same sentence can be found in many other rulings:\(^6\)

> "Although direct taxation is a matter for the Member States, they must nevertheless exercise their direct taxation powers consistently with Community law"\(^7\)

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5 Case C-264/96 Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes) [1998] ECR I-4695.


7 Case C-264/96 Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes) [1998] ECR I-4695, para. 19.
Thus, with one simple sentence, the ECJ has in effect extended the scope of Community law to matters of income taxation, as long as they concern cross-border situations.

2.2.2 Avoir Fiscal
The *Avoir Fiscal* case is often referred to as the first case in which the ECJ ruled on the compatibility of a Member State’s income tax legislation with Community law and the rules on free movement. The case concerned a tax credit (the *avoir fiscal*) provide for by French legislation, which was not granted to branches in France of non-resident companies on the same terms as those enjoyed by French companies. Since French law treated companies registered in France and branches of companies with their registered office in other Member States the same, when it came to the taxation of their profits, dissimilarity when it came to granting a tax advantage was not accepted. The French government’s attempts to justify this difference in treatment were shot down by the Court. Among the rejected justifications were advantages for branches which would cancel out the disadvantages that came with not being granted the tax credit, the lack of harmonization of Member States’ laws on corporation tax and the risk of tax avoidance. Finally, and perhaps most relevant to this thesis, the French government argued that the difference in treatment was due to double taxation agreements. The ECJ brushed this aside by stating that such agreements did not deal with the questions relevant to the issue at hand. The Court added that Member States could not make respect for the unconditional rights conferred by the free movement provisions subject to the contents of agreements conclude with other Member States, in particular not to conditions of reciprocity, designed to obtain corresponding advantages from other Member States.

2.2.3 Comparability of residents and non-residents
The *Schumacker* case contains some important statements made by the ECJ, which have had great impact on the case law that followed. Perhaps the most important principle among these is what has been dubbed “the Schumacker doctrine”, namely that the situation of a resident and the situation of a non-resident is not as a rule comparable, with regard to income tax. The reasoning behind this principle was that the income earned by a non-resident in a Member State, other than the one in which he is resident, is normally only a part of his total income. The majority of his income is earned in his state of residence. It was also held that it is the state of residence that has easier access to the information necessary to assess a resident taxpayer’s ability to pay his taxes, taking account of his personal and

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9 *Ibid*, paras. 3-4.
16 *Ibid*, para. 32.
family circumstances.\(^{17}\) It is important to note that this is a general rule and that, depending on the case, the situations of residents and non-residents can be held to be comparable. This is often the case in situations where the non-resident earns no income or only a small part of his income in his state of residence, and instead derives the majority of his income from another Member State.\(^{18}\)

### 2.2.4 Accepted grounds of justification

Over the years, several justifications for restrictions to the free movement and non-discrimination principles in matters of direct taxation have been tried by the ECJ. Among these, there are a few who have been, at least in principle, considered acceptable by the Court. These accepted justifications are: the prevention of tax abuse\(^{19}\), ensuring the cohesion of the tax system\(^{20}\), the effectiveness of fiscal supervision\(^{21}\) and (possibly) the protection of the territoriality principle\(^{22}\) in tax law.\(^{23}\)

### 2.2.5 Rejected grounds of justification

Most of the attempts at justifying restrictions and unequal treatment in the field of direct taxes have been rejected by the ECJ. However, it is interesting to note that the Member States’ governments in some cases continue to rely on the same justifications time and time again, even when they have been denied many times before. One can assume that the governments continue to bring up these justifications because they are hoping that the ECJ will change their attitude towards them.\(^{24}\) Among the justifications that the Member States have repeatedly tried to rely on, there are some that have been especially prevalent, such as the Community having no competence on matters of direct taxation or tax treaty law\(^{25}\), possible advantages compensating for disadvantages brought on by discrimination\(^{26}\), the option

\(^{17}\) Ibid, para. 33.

\(^{18}\) Ibid, para. 37.

\(^{19}\) See for e.g. case C-324/00 Lankhorst Hoberst GmbH v Finanzamt Steinfurt [2002] ECR I-11779. For a discussion on the differences between the concepts of tax abuse, tax evasion and tax avoidance, see Dahlberg, M, Internationell beskattnings, Studentlitteratur, Lund, 2005, p. 236-237.

\(^{20}\) See e.g. case C-204/90 Hanns-Martin Bachmann v Belgian State [1992] ECR I-249.

\(^{21}\) See e.g. case C-250/95 Futura Participations SA and Singer v Administration des contributions [1997] ECR I-2471.

\(^{22}\) See e.g. case C-250/95 Futura Participations SA and Singer v Administration des contributions [1997] ECR I-2471. See also Dahlberg, M, Internationell beskattnings, p. 242-248.

\(^{23}\) Dahlberg, M, Internationell beskattnings, p. 235-236.

\(^{24}\) Ibid, p. 248.

\(^{25}\) See section 2.2.1.

\(^{26}\) See e.g. case C-330/91 The Queen v Inland Revenue Commissioners, ex parte Commerzbank AG [1993] ECR I-4017.
to choose another form of establishment\textsuperscript{27}, and lastly protection, both of the taxable base as well as against the loss of tax revenue\textsuperscript{28,29}.

### 2.3 EC directives on direct taxation

Four directives, that deal specifically with direct taxes in the EU, emerge as especially interesting: the Parents-Subsidiary directive\textsuperscript{30}, the Mergers directive\textsuperscript{31}, the Interests and Royalties directive\textsuperscript{32} and the Savings Interest directive\textsuperscript{33}. Another directive of great importance in this area is the direct tax directive on Mutual Assistance\textsuperscript{34}.

The aim of the Parents-Subsidiary directive is to eliminate the disadvantages of cooperation between companies of different Member States, when compared to cooperation between companies within one Member States, and at facilitating the transfrontier grouping together of companies within the EC. This is to be achieved through the abolishment of tax impediments, such as withholding taxes, to cross-border payment of dividends within groups of companies, thereby ensuring the effective functioning of the internal market.\textsuperscript{35}

The Mergers directive is aimed at combating the tax problems encountered when two or more companies of different Member States join together, or when companies divide into separate entities in different Member States. Those tax problems are, specifically, those connected to unfavourable tax treatment of such cross-border mergers and divisions when compared to domestic mergers and divisions.\textsuperscript{36}

The main objective of the Interests and Royalties directive is to abolish tax impediments on cross-border interest and royalty payments within groups of companies. National tax laws, coupled with tax treaty provisions, do not always ensure that the double taxation of such payments is eliminated. In addition, the application of such measures often entails cumbersome administrative formalities. In order to eliminate the problems mentioned and to ensure the equal treatment of cross-border and domestic transactions, the method of abolishing...

\begin{itemize}
\item \textsuperscript{27} See e.g. case 270/83 Commission v France [1986] ECR 273 (“Avoir Fiscal”).
\item \textsuperscript{28} See for e.g. cases C-264/96 Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes) [1998] ECR I-4695 and C-324/00 Lankhorst Hohorst GmbH v Finanzamt Steinfurt [2002] ECR I-11779.
\item \textsuperscript{29} Dahlberg, M, Internationell beskattning, p. 248-252.
\item \textsuperscript{31} Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States.
\item \textsuperscript{32} Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.
\item \textsuperscript{34} Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation.
\item \textsuperscript{36} \textit{Ibid}, p. 535-536.
\end{itemize}
ing withholding taxes on the payments in question was deemed the most appropriate solution.\textsuperscript{37}

The Savings Interest directive is designed to combat the problem of tax avoidance in the state of residence, on savings interest received in another Member State. That situation was held to create distortions in the capital movements between Member States, thereby having an adverse effect on the internal market. The aim of the directive is the effective taxation of savings income in the form of interest payments in the home state of the individual recipient, though exchange of information.\textsuperscript{38}

The direct tax directive on Mutual Assistance was adopted in 1977 and have since been amended a number of times. The directive is intended to combat distortions of the conditions of competition brought on by international tax avoidance and evasion, as well as over-taxation of cross-border economic activities.\textsuperscript{39} Even though there are many bilateral tax treaties between the EU Member States, they do not cover all situations in which such problems can occur. The directive aims to prevent such situations from arising by facilitating the exchange and sharing of information between the tax authorities from the different Member States. The ECJ obviously places this directive in high regard, noticeable by the amount of cases in which an attempt to justify unequal treatment in tax matters have not been accepted, with specific reference to the directive.\textsuperscript{40}

2.4 Case law on tax treaties and EC law

2.4.1 Concerning the cases

There are a limited number of cases in which the ECJ has ruled on the compatibility of tax treaty provisions with Community law.\textsuperscript{41} Of those few cases, three stand out as especially interesting: \textit{Gilly}\textsuperscript{42}, \textit{Saint-Gobain}\textsuperscript{43} and \textit{de Groot}\textsuperscript{44}.\textsuperscript{45}

The \textit{Gilly} case was the first case in which the Court specifically investigated the compatibility of a tax treaty provision with the Community principles of free movement.\textsuperscript{46} Interestingly, the ECJ did not follow its usual line of reasoning.

\textsuperscript{37} Ibid, p. 625-628.

\textsuperscript{38} Ibid, p. 645-646.

\textsuperscript{39} Ibid, p. 675.

\textsuperscript{40} See e.g. the justification of effective fiscal supervision in the case C-250/95 \textit{Futura Participations SA and Singer v Administration des contributions} [1997] ECR I-2471.


\textsuperscript{42} C-336/96 \textit{Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin} [1998] ECR I-2793.


\textsuperscript{44} C-385/00 \textit{F.W.L. de Groot v Staatssecretaris van Financiën} [2002] ECR I-11819.

\textsuperscript{45} Hilling, M, Free Movement and Tax Treaties in the Internal Market, p. 242.

\textsuperscript{46} Ibid, p. 247.
However, in Saint-Gobain, which came after, the conclusion of the Court was more firmly grounded in previous case law than the decision in the Gilly case.

The next case is de Groot, in which the Court continued ruling in a way that was in line with established case law.

Some interesting arguments have been laid down in the literature as to why the Court used a different reasoning in Gilly than in the subsequent cases. This will be further discussed below.

2.4.2 Gilly

2.4.2.1 Background

The applicants in the main proceedings before the national court were the Gillys, a married couple who lived in France near the German border. Both Mr and Mrs Gilly were employed as teachers. Mr Gilly, a French national, worked in the French state school and Mrs Gilly, a German national who had also attained French nationality by way of her marriage, worked in a German state school.47 Mr and Mrs Gilly argued before the national court in France that the application of a number of provisions in the French-German double taxation treaty led to unjustified, discriminatory and excessive taxation which was incompatible with Articles 12, 39 and 293 EC. The French court (the Tribunal Administratif in Strasbourg) referred the question to the ECJ in order to get a preliminary ruling.48

The questions posed by the national court will here be mentioned in the order that they were answered by the ECJ.

2.4.2.2 Direct applicability of the second indent of Article 293 EC

Firstly, the Court addressed a question regarding the second indent of Article 293 EC. The second indent contains the objective of Member State to enter into negotiations with each other in order to abolish double taxation within the Community. The national court had in one of its questions raised the issue of whether or not this objective had become directly applicable, with regard to the time the Member States had had to implement it.49

The ECJ referred to earlier case law and held that Article 293 EC is not intended to lay down a legal rule directly applicable as such. The abolition of double taxation is merely one of several objectives of negotiations that the Member States shall enter into with each other if it is necessary. It is clear from the wording of the provision that it cannot itself confer any rights on individuals that they in turn would be able to rely on before their national courts. Thus, the answer to the question was that the second indent of Article 293 EC does not have direct effect.50

47 C-336/96 Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin [1998] ECR I-2793, para. 3.
50 Ibid, paras. 15-17.
2.4.2.3 Compatibility of distribution provisions of the treaty with Article 39 EC

The Court first established that the situation at hand, contrary to the opinion of the French government, fell within the scope of Article 39 EC. The French government held that the situation of Mrs Gilly did not involve the freedom of movement for workers, since she worked in Germany, “her state of origin”. The ECJ firmly rejected this. While Mrs Gilly had German nationality, she also had French nationality and was resident in France. She was therefore considered a French resident and national that exercised her right to freedom of movement when she worked in another State and the fact that she also had the nationality of the State in which she was employed was of no consequence.  

The Court then moved on to questions on various distribution provisions in the double taxation treaty and if they complied with Article 39 EC or not. To be more precise, the relevant provisions were Articles 13(5) (a), 14(1) and 16 of the tax treaty.

Article 13(5) (a) contained an exception to the main principle concerning dependent work, found in Article 13(1). Article 13(1) basically states that income derived from dependent work shall be taxed only in the contracting state in which the work is carried out. The exception found in 13(5) (a) concerned frontier workers. Those workers who work in the frontier area of one contracting state, but have their permanent residence in the other contracting state and normally return there each day, are taxed on their income only in that latter state.

However, the first sentence of Article 14(1) of the tax treaty states that taxpayers who receive remuneration and pensions from the public sector are taxable only in the paying State. This is referred to as the “paying State principle”. The second sentence of the same Article provides for an exception from this principle: remuneration paid to persons having the nationality of the State of residence, without at the same time having the nationality of the paying State, shall be taxed only in the State of residence.

Lastly, Article 16 lays down a special connecting rule applicable to teachers who, during a temporary residence period not exceeding two years, live in one of the contracting states and receive remuneration for teaching in that State. Those taxpayers who this rule applies to are to be taxed only in the state of original employment.

All of the above mentioned provisions lay down different connecting factors in order to allocate taxing jurisdiction between the two states. Article 14(1) is, however, the most interesting one from an EC law compatibility standpoint, since the decisive criteria in the second sentence is nationality. It was also this provision that the ECJ primarily addressed in their answer. Since Mrs Gilly had dual nationality, this meant that she did not fall under the exception in the second sentence. Thus, she was taxed in the paying State, i.e. Germany.

Before ruling on the compatibility of the distribution articles with Article 39 EC, the Court first identified the context in which the French-German double taxation treaty had been

51 Ibid, paras. 19-22.
52 Ibid, paras. 4-5.
53 Ibid, paras. 6 and 27.
54 Ibid, paras. 7 and 28.
55 Hilling, M, Free Movement and Tax Treaties in the Internal Market, p. 252.
concluded. Firstly, while the abolition of double taxation within the Community is one of the objectives of the EC Treaty, no general unifying or harmonizing measures for the elimination of double taxation have been adopted at Community level, nor have the Member States concluded any multilateral treaty to that effect. Secondly, the Member States are competent to determine the criteria for taxation in order to eliminate double taxation, for example by concluding bilateral agreements based on the OECD Model Tax Treaty.

After this, the ECJ ruled that although the criterion of nationality appears in Article 14(1) for the purpose of allocating taxing jurisdiction, such differentiation could not be regarded as constituting discrimination prohibited under Article 39 EC. The Court based this decision on the fact that it was within the contracting parties’ competence to, in the absence of any harmonizing Community measures, between themselves define the criteria for allocating their powers of taxation, in order to eliminate double taxation. Neither is it unreasonable for Members States, when deciding on the allocation of their fiscal jurisdiction, to base their agreements on international practice and the OECD model treaty. Special reference was made to Article 19(1) of the 1994 version of the OECD Model, which provides for recourse to the paying state principle. The ECJ quoted the commentaries on that particular article, according to which the paying state principle was justified by “the rules of international courtesy and mutual respect between sovereign States” and “is contained in so many existing treaties between OECD member states that it can be said to be already internationally accepted”. While not identical to Article 14(1) of the French-German double taxation treaty, this OECD model article included an exception based on nationality that made it very similar.

Apart from the above mentioned reasons, the ECJ also held that even if the nationality criterion in the second sentence of Article 14(1) were to be ignored, Mrs Gilly would still be taxed in Germany. Because she was teaching in the state education system in Germany, her income would still be taxed there according to the paying state principle.

Lastly, the ECJ agreed with the observations of the Commission and some Member States:

“... whether the tax treatment of the taxpayers concerned is favourable or unfavourable is determined not, strictly speaking, by the choice of connecting factor but by the level of taxation in the competent State, in the absence of any Community harmonisation of scales of direct taxation”.

Thus, the choice of the paying State as the State competent to tax cannot of itself be to the disadvantage of the taxpayer.

57 Ibid, para. 24.
58 Ibid, para. 30.
59 Ibid, para. 30.
60 Ibid, para. 31.
61 Ibid, para. 32.
62 Ibid, para. 33.
63 Ibid, para. 34.
To summarise, the Court held that Article 39 EC does not preclude application of double taxation treaty provisions such as those in question.\textsuperscript{64}

\subsection*{2.4.2.4 \textbf{Compatibility of distribution provisions of the treaty with Article 12 EC}}

The national court also posed the question on whether or not Article 12 EC precluded the application of a provision such as that contained in the second sentence of Article 14(1) of the French-German treaty.\textsuperscript{65}

The ECJ swiftly dismissed this question by stating that the general principle of the prohibition of discrimination as found in Article 12 EC, has as regards to the freedom of workers been specifically implemented and embodied in Article 39 EC.\textsuperscript{66} Therefore, as the situation at hand had already been judged to fall within the scope of Article 39 EC, it was held as unnecessary to rule on the interpretation of Article 12 EC.\textsuperscript{67}

\subsection*{2.4.2.5 \textbf{Compatibility of method provision of the treaty with Article 39 EC}}

Article 20(2) (a) (cc) of the French-German treaty contains the following method provision, for the avoidance of double taxation:

\begin{quote}
2. Double taxation of persons resident in France shall be avoided in the following manner:

(a) Profits and other positive income arising in the Federal Republic and taxable there under the provisions of this Convention shall also be taxable in France where they accrue to a person resident in France. The German tax shall not be deductible for calculation of the taxable income in France. However, the recipient shall be entitled to a tax credit to be set against the French tax charged on the taxable amount which includes that income. That tax credit shall be equal:

...  

(cc) for all other income, to the amount of the French tax on the relevant income. This provision shall apply in particular to the income referred to in Articles ... 13(1) and (2) and 14."
\end{quote}

As regards Mrs. Gilly, this meant that although Germany had jurisdiction to tax her income, the same income would also be subject to tax in France. However, she would be entitled to a tax credit in France, which was limited to the amount of French tax paid on the relevant income. As the national court pointed out, the use of this method meant that the tax credit to be set against the French tax may be less than the actual tax paid in Germany when the applicable tax rate in Germany was higher than the one in France.\textsuperscript{68} This was the situation in Mrs. Gilly’s case.

\textsuperscript{64} Ibid, para. 35.

\textsuperscript{65} Ibid, para. 36.

\textsuperscript{66} Ibid, paras. 37-38.

\textsuperscript{67} Ibid, para. 39.

\textsuperscript{68} Ibid, para. 10.
The question posed by the national court was whether or not Article 39 EC precluded the application of a tax credit mechanism such as the one provided for in Article 20(2)(a)(cc) of the French-German treaty.\(^69\) The ECJ began by commenting on the purpose of the tax credit mechanism in question (the avoidance of double taxation) and noted that it was based on the OECD Model.\(^70\)

The Court then acknowledged that Mrs Gilly’s personal and family circumstances were not taken into account when calculating the tax on her income in Germany, while they were taken into consideration when calculating the tax payable in France.\(^71\) This fact and the fact that the German tax scale had a greater degree of progressivity meant that the amount of tax credit in France was always lower than the tax actually paid in Germany. Thus, those who exercise their freedom of movement are, in this specific case, penalised by the tax credit mechanism since it allows a degree of double taxation to remain.\(^72\)

The applicants in the main proceedings submitted that this double taxation could be fully avoided if a full credit was allowed in France, equal to amount of tax actually paid in Germany.\(^73\) This was observed upon by the governments of France, Belgium, Denmark, Finland, Sweden and the United Kingdom. In their view, if the state of residence was forced to offer a full tax credit, it would have to reduce its tax as regards the remaining income, which would entail a loss of tax revenue. Ultimately this would lead to an encroachment on the sovereignty of the Member States in matters of direct taxation.\(^74\)

With reference to the Advocate General’s (AG) Opinion\(^75\), the Court stated that:

> “The object of a convention such as that in issue is simply to prevent the same income from being taxed in each of the two States. It is not to ensure that the tax to which the taxpayer is subject in one State is no higher than that to which he or she would be subject in the other.”\(^76\)

Further, the ECJ stated that any unfavourable consequences entailed in the present case by the tax credit mechanism in the double taxation treaty, implemented in the context of the tax system of the State of residence, are the result in the first place of the differences between the tax scales of the Member States in question. In the absence of Community legislation on the matter, it is for the Member States to decide on those scales.\(^77\)

Regarding the fact that a taxpayer’s personal and family circumstances are take into account in the state of residence but not in the state of employment and the effect this has on the amount of tax the tax credit, the Court held that this disparity is due to the fact that the

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\(^69\) Ibid, para. 40.

\(^70\) Ibid, para. 41.

\(^71\) Ibid, para. 43.

\(^72\) Ibid, para. 44.

\(^73\) Ibid, para. 45.

\(^74\) Ibid, para. 48.

\(^75\) C-336/96 Opinion of Mr Advocate General Ruiz-Jarabo Colomer delivered on 20 November 1997. Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin.

\(^76\) C-336/96 Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin [1998] ECR I-2793, para. 46.

\(^77\) Ibid, para. 47.
situations of residents and non-residents are not as a rule comparable in the field of direct taxation. This incomparability is because income received in the territory of a State by a non-resident is usually only part of his or her total income, while the opposite is true for a resident.\textsuperscript{78}

In light of what has been presented above, the ECJ came to the conclusion that Article 39 EC did not preclude the application of a tax credit mechanism such as could be found in Article 20(2)(a)(cc) of the French-German double taxation treaty.\textsuperscript{79}

\subsection{Comments}

The ruling in the \textit{Gilly} case is interesting in many ways, not only because it was the first case in which tax treaty provisions were tested for compatibility with Community law. The way the Court arrives at its ruling, in some ways clashes with previously established case law.

For instance, the ECJ did not follow its ordinary test when trying to decide if a measure constituted discrimination based on nationality: whether or not the taxpayers were in objectively different circumstances.\textsuperscript{80} Instead, the Court simply stated that the differentiation based on nationality found in the tax treaty distribution provision could not be held to constitute a discrimination prohibited under Article 48 EC.\textsuperscript{81}

The lack of harmonization and the basing of international agreements on internationally accepted practices and the OECD Model were some of the justifications brought forward for the conclusion reached by the ECJ. However, the lack of harmonization as a justification for discriminatory tax treatment had previously been turned down by the Court, for example in the pivotal \textit{Avoir Fiscal} case.\textsuperscript{82}

One conclusion that can be drawn from the \textit{Gilly} case and which came to be significant in later cases was that tax treaty rules which merely allocate the power of taxation are neutral and unable to be discriminatory, even if the provision in question contains a criterion based on nationality. This is because pure tax jurisdiction allocation is not in any way related to the actual tax treatment in the states which are party to the tax treaty.\textsuperscript{83}

As for the tax treaty provision which called for the use of a tax credit method, the ECJ paid regard to the aim of the tax treaty. This stands in contrast to the Court’s rulings on the compatibility of internal tax legislation with Community law, where it normally does not put any significance to the aim behind the relevant tax measure.\textsuperscript{84}

The Court did not, as was normal in cases both before and after \textit{Gilly}, put forward any reasoning on whether or not the method provision made the exercise of free movement rights

\begin{thebibliography}{99}
\bibitem{78} \textit{Ibid}, para. 49.
\bibitem{79} \textit{Ibid}, para. 54.
\bibitem{80} Hilling, M, Free Movement and Tax Treaties in the Internal Market, p. 254.
\bibitem{81} C-336/96 \textit{Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin} [1998] ECR I-2793, para. 30.
\bibitem{82} Hilling, M, Free Movement and Tax Treaties in the Internal Market, p. 255.
\bibitem{83} \textit{Ibid}, p. 256-257.
\bibitem{84} \textit{Ibid}, p. 258.
\end{thebibliography}
any less attractive. Instead, the objective of tax treaties and the OECD Model was referred to.\textsuperscript{85}

In the literature\textsuperscript{86}, the change in reasoning by the Court has been attributed to an attempt to keep a cautious approach to dealing with provisions in tax treaties based on the internationally accepted OECD Model. The ECJ is normally not against striking down on the unilateral, internal tax legislation of a Member State, but when the provision in question can be found in a bilateral treaty which in turn is based on a widely used model treaty, it becomes a quite different matter altogether. The consequences of declaring such a provision incompatible with Community law could be far-reaching. The use of the OECD Model as a basis for treaties concluded in the field of international double taxation is widespread and if the ECJ does not accept a provision based on it, the result could very well be that the balance of the tax treaty network would be disturbed, as the same could happen to any other tax treaty between Member States which contained a similar rule.\textsuperscript{87}

As regards the method provision, the rationale behind the somewhat unusual reasoning of the Court has been put forward as being the negative consequences that would have followed had the Court ruled that the provision was precluded by Article 39 EC. Many Member States apply an ordinary tax credit method in their tax treaties, and “forcing” them to instead use a full credit method, would not have been well received by their governments. Indirectly, this would make a states’ tax revenue dependent on the tax rates of other states, which might in turn cause Member States to avoid concluding tax treaties. In the end, such situation would not benefit the internal market.\textsuperscript{88}

The above reasons explain why the ECJ is very careful when dealing with provisions based on the OECD Model. The Court can even rely on arguments that are inconsistent with established case law, in order to ensure a good result. However, as shown in the later \textit{Saint-Gobain} case, this does not mean that Member States who base their tax treaty provisions on the OECD Model are given an “automatic pass” when it comes to compliance with free movement law.\textsuperscript{89}

\subsection*{2.4.3 \textbf{Saint-Gobain}}

\subsubsection*{2.4.3.1 Background}

Saint-Gobain ZN was a branch, located in Germany, of the French company Saint-Gobain SA. For the purpose of German tax law, the former company was treated as a permanent establishment (PE) of Saint-Gobain SA. Since Saint-Gobain SA did not have it seat or its business management in Germany, it was subject to limited tax liability in that State. This limited tax liability extended to the income earned of, as well as the assets held by, the PE - Saint-Gobain ZN.\textsuperscript{90}

\begin{footnotesize}
\begin{enumerate}[\textsuperscript{85}, p. 259.]
\item Ibid, p. 260.
\item Ibid, p. 254-256.
\item Ibid, p. 260-261.
\item Ibid, p. 254.
\item C-307/97 \textit{Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt} [1999] ECR I-6161, paras 3-5.
\end{enumerate}
\end{footnotesize}
Saint-Gobain SA held, through the operating capital of Saint-Gobain ZN, shareholdings in one company established in the USA as well as in two German subsidiaries. The German subsidiaries in turn had shareholdings in companies established in Austria, Italy and Switzerland. Due to German group treatment legislation, the dividends distributed from the American, Austrian, Italian and Swiss companies were included in the taxable profits of Saint-Gobain ZN.\textsuperscript{91}

The German Finanzamt (Tax Office) refused to grant Saint-Gobain SA three tax concessions relating to the taxation of dividends from shares in foreign companies limited by shares. At that time, those concessions were restricted to companies who were subject to unlimited tax liability in Germany.\textsuperscript{92} Saint-Gobain ZN challenged this refusal in front of the national court, which in turn referred the question on whether or not the German rules complied with Article 43 and Article 48 EC to the ECJ.

2.4.3.2 Refusal to grant tax concessions to permanent establishments

The three tax concessions that were refused Saint-Gobain SA were the following:

1. An exemption from German corporation tax for dividends received from companies established in non-member states, provided for by a tax treaty concluded with a non-member state. The exemption was restricted to German companies and companies which were subject to unlimited tax liability in Germany.\textsuperscript{93}

In the case of the first concession, the non-member states with which tax treaties had been concluded were Switzerland and the USA.

2. A credit against German corporation tax of the corporation tax levied in a State other than Germany on the profits of a subsidiary established there, provided for by German internal legislation. The credit was restricted to companies subject to unlimited tax liability in Germany.\textsuperscript{94}

3. An exemption from capital tax for shareholding in companies established in non-member states also provided for by German internal legislation. The exemption was restricted to German companies limited by shares.\textsuperscript{95}

It is worth mentioning that German law was later changed so that PEs were also entitled to the above listed benefits. However, since the changes only took effect until after the 1994 tax period, this could not be taken into account in the main proceedings where 1988 was the relevant year.\textsuperscript{96}

The ECJ began its answer by underlining the fact that Articles 43 and 48 EC confer upon nationals of Member States who have exercised their freedom of establishment as well as companies or firms which are assimilated to them, the right to the same treatment in the

\textsuperscript{91} Ibid, paras. 9-14.

\textsuperscript{92} Ibid, para. 8.

\textsuperscript{93} Ibid, paras. 16-18.

\textsuperscript{94} Ibid, paras. 19-20.

\textsuperscript{95} Ibid, paras. 21-22.

\textsuperscript{96} Ibid, paras. 25-29.
host Member State as that which is given to nationals of that Member State.\textsuperscript{97} The Court also stated as it had in the past, that for companies, the seat is the connecting factor to a Member State’s legal order, just as nationality is for natural persons.\textsuperscript{98}

The ECJ then went on to define the practice at hand in the case, which was the refusal of certain tax concession to a non-resident company, where those tax concessions were restricted to companies being subject to unlimited tax liability in Germany.\textsuperscript{99} Reference was made to German law, where companies subject to unlimited tax liability were companies considered to be resident in Germany for tax purposes, which in turn meant companies that had their registered office or business management in Germany. This meant that the criterion for granting tax concession was the company’s corporate seat, and that the refusal to grant them primarily affected non-resident companies.\textsuperscript{100} The Court found that the granting of certain tax concessions gave the companies to which they were granted a lighter tax burden and consequently the PEs of non-resident companies, who were refused those same concessions, were in a less favourable situation than resident companies, including German subsidiaries of non-resident companies.\textsuperscript{101} It was therefore less attractive for non-resident companies to do business in Germany through a branch than to establish a subsidiary. In other words, there was a breach of the right to choose the most appropriate legal form to pursue activities in another Member State, conferred upon economic operators by Article 43 EC.\textsuperscript{102}

The ECJ concluded that the difference in treatment between branches of non-resident companies and resident companies as well as the restriction of the freedom to choose the form of secondary establishment constituted a single combined infringement of Articles 43 and 48 EC.\textsuperscript{103} As a result, the next question that had to be answered was if this difference in treatment could be justified under EC law.\textsuperscript{104}

The German government argued in favour of a number of justifications, the first of which was that in the field of direct taxation, the situations of resident and non-resident companies are not as a rule comparable. PEs of non-resident companies in Germany were argued to be in objectively different situations from companies resident in Germany, because of the former being subject to limited tax liability and the latter being subject to unlimited tax liability.\textsuperscript{105} The Court, in response, held that PEs of non-residents and resident companies were in objectively comparable situations as regards the liability to tax on dividend receipts in Germany from shares in foreign subsidiaries and sub-subsidiaries on the holding of those shares. This was because the liability to tax would be the same regardless of whether

\textsuperscript{97} Ibid, para. 34.  
\textsuperscript{98} Ibid, para. 35.  
\textsuperscript{99} Ibid, para. 36  
\textsuperscript{100} Ibid, para. 37.  
\textsuperscript{101} Ibid, para. 38.  
\textsuperscript{102} Ibid, para. 42.  
\textsuperscript{103} Ibid, para. 43.  
\textsuperscript{104} Ibid, para. 44.  
\textsuperscript{105} Ibid, paras. 45-46.
the recipient of the dividends was a PE or a subsidiary. The situations were considered to be even more comparable by the fact that the difference in treatment applied only to the grant of the tax concessions.

Next, the German government cited the need to prevent a reduction of tax revenue as a justification for the refusal to grant tax concessions to PEs in Germany. The Court dismissed this by stating that the reduction of tax revenue was not one of the grounds listed in Article 46 EC, and neither could it be regarded as a matter of overriding general interest capable of being relied upon to justify unequal treatment.

The subsequent argument was that the disparity could be justified by other advantages that PEs enjoyed in comparison to resident subsidiaries. The ECJ denied this attempt at justification as well and stated that a difference of treatment could not be offset by other advantages, which even if they existed could not justify breach of the obligation laid down in Article 43 EC.

Lastly, the German government put forward the argument that the conclusion of bilateral treaties with non-member states did not fall within the scope of Community competence and that “to extend to other situations the tax advantages provided for by treaties concluded with non-member states would not be compatible with the division of competences under Community law”. The Swedish government added their observation that double-taxation treaties were based on the principle of reciprocity and if the benefit of their provisions were to be extended to Member States that were not party to the conclusion of the treaty, the balance inherent in such treaties would be disturbed. The ECJ held that the Member States were competent to, in the absence of any harmonising measures adopted by the Community, between themselves determine the connecting factors for the purposes of allocating the power of taxation, in particular by concluding bilateral agreements. However, when exercising that power of taxation, the Member States must still do so with regard to Community rules.

As the Court applied the above reasoning to the situation at hand in the case, Member States which were party to a double-taxation treaty with a non-member state were required, under the national treatment principle, to grant PEs of non-resident companies the advantages provided for by that treaty on the same conditions as those which apply to resident companies. Furthermore, it was held that the balance and reciprocity of the tax treaties Germany had with Switzerland and the USA would not be called into question by a unilateral extension of the category of recipients in Germany who would be able to benefit from

106 Ibid, para. 47.
107 Ibid, para. 48.
110 Ibid, para. 54.
111 Ibid, para. 55.
112 Ibid, para. 56.
113 Ibid, para. 57.
114 Ibid, para. 58.
the treaty. Such an extension would in no way affect the rights and obligations of the non-member states which are parties to the treaty.\footnote{\textit{Ibid}, para. 59.}

Thus, the answer given by the Court was that Articles 43 and 48 EC precluded the exclusion of PEs of companies established in another Member State from benefiting from tax concessions such as those in question on the same conditions as companies established in the host state.\footnote{\textit{Ibid}, para. 63.}

\textbf{2.4.3.3 Comments}

When comparing the ruling in \textit{Saint-Gobain} to the one in the \textit{Gilly} case, the ECJ employed a reasoning that was more in line with previous cases. The Court paid regard to the effects of the legislation in question, as well as establishing comparable situations, in this case the situation of a PE to a non-resident company and the situation of a resident company.\footnote{Hilling, M, Free Movement and Tax Treaties in the Internal Market, p. 269.}

The question may then be raised as to what the difference is that made the Court apply such different approaches to the reasoning used in the \textit{Saint-Gobain} case compared to the \textit{Gilly} case. They both concerned tax treaty provisions and compatibility with free movement law. It has already been established that the reason for the Court’s ruling in \textit{Gilly} most likely had to do with an unwillingness to disturb the tax treaty network, which in large parts is based on the OECD Model. This is also the key to understanding the difference between \textit{Gilly} and \textit{Saint-Gobain}. In \textit{Saint-Gobain}, it was possible for the PE-state to extend the tax treaty benefits to PEs without it having a negative impact on the functions of the relevant tax treaties. In fact, that solution was even mentioned in the Commentaries\footnote{OECD Commentary on the Model Convention 2005.} to the OECD Model.\footnote{OECD Commentary on Article 25, paras. 29-35.} Accordingly, the ECJ could serve the internal market without at the same time negatively impact the tax treaty network within the Union, and so had no problem with striking down on tax treaty provisions in breach of EC Treaty rules on free movement.\footnote{Hilling, M, Free Movement and Tax Treaties in the Internal Market, p. 271.}

Another interesting aspect of the \textit{Saint-Gobain} judgement is that the Court differentiates between allocation of the power of taxation and the exercise of the same. The allocation of powers of taxation had previously (in \textit{Gilly}) been regarded as free for the Member States to work out between themselves. In \textit{Saint-Gobain}, this is reaffirmed, with the addition that the exercise of the power of taxation must nevertheless be done in line with Community rules.\footnote{C-307/97 \textit{Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt} [1999] ECR I-6161, para. 57.} This is an important distinction.\footnote{See section 3.2.2.}

One question that has been raised in the wake of the \textit{Saint-Gobain} case is what the judgement implies for the status of PEs that are taxed in the PE-state in the same way as resi-
dent companies. More specifically, two alternatives have emerged. The first alternative is that the *Saint-Gobain* ruling meant that PEs should be entitled to full resident status for tax treaty purposes. This would signify a great change in how PEs normally are treated for tax treaty purposes and imply an obligation on the source state (as long as it is an EU Member State), from which dividends are paid, to accept the resident status of a PE and consequently apply the limited tax rate on outgoing dividends, provided for in the tax treaty with the PE-state. The second alternative has a more limited impact, and would simply imply an obligation on the PE-state to grant the same treaty benefits to PEs as to resident companies. This second alternative would not entail any change for the source state. It is this alternative that has been held as being more likely in the literature. This is also somewhat supported by the reasoning of the Court.\(^{123}\)

\section*{2.4.4 de Groot}

\subsection*{2.4.4.1 Background}

Mr de Groot, a Dutch resident, was up until 1994 employed in the Netherlands, as well as in Germany, France and the United Kingdom.\(^{124}\) Double taxation was avoided on the income derived from these Member States by way of bilateral tax treaties between them and the Netherlands.\(^{125}\) The method used by all of these treaties was exemption with progression, as provided for by Article 23(1) and (3) of the OECD Model Treaty.\(^{126}\) However, the method used deviated from the Model by way of application of what is known as a *pro rata parte* method.\(^{127}\) This method was provided for directly in the German and French tax treaties and referred to in Dutch internal legislation by the UK tax treaty.\(^{128}\)

The *pro rata parte* method as was provided for by Dutch law and the German and French tax treaties, meant that when calculating exemption with progression, allowances related to the taxpayers’ personal and family circumstances were distributed over his total income. Thus, allowances were deductible from the tax payable in the Netherlands only in proportion to the income received by the taxpayer in the Netherlands when compared to the total income.\(^{129}\)

Had the source states taken Mr de Groot’s personal and family circumstances into account and granted him the corresponding deductions, the *pro rata parte* method would had functioned well.\(^{130}\) However, the fact that they did not, meant that he received less tax relief on account of personal liabilities borne by him, and was able to take less advantage of the tax-


\(^{124}\) C-385/00 F.W.L. de Groot v Staatssecretaris van Financiën [2002] ECR I-11819, para. 27.

\(^{125}\) Ibid, paras. 5-6.

\(^{126}\) Ibid, para. 12.

\(^{127}\) Hilling, M, Free Movement and Tax Treaties in the Internal Market, p. 272.


\(^{129}\) Ibid, para. 26.

\(^{130}\) Hilling, M, Free Movement and Tax Treaties in the Internal Market, p. 273.
free allowance than he would have been able to had he derived his total income from the Netherlands only.\textsuperscript{131}

Mr Groot challenged this system in the Netherlands and the national court eventually submitted the case before the ECJ. The questions referred to the Court were firstly, if Article 39 EC precluded rules such as those at issue, irrespective of whether or not they were laid down in a treaty for the avoidance of double taxation, and secondly, if the first question was answered in the affirmative, if Community law contained any special requirements with regard to how personal and family circumstances of an employee must be taken into account in his state of residence.\textsuperscript{132}

\textbf{2.4.4.2 Compatibility of pro rata parte method with Article 39 EC}

The ECJ, when trying to ascertain whether or not there was an obstacle to freedom of movement of workers, began by stating that it was undisputed that Mr de Groot had exercised his right to freedom of movement of workers under Article 39 EC.\textsuperscript{133}

The fact that the application of the \textit{pro rata parte} method led to a lesser tax advantage for Mr de Groot than if he had received all his income in the Netherlands, meant that he had suffered a real tax disadvantage, which was liable to discourage a Dutch national from leaving for another Member State to take up employment there.\textsuperscript{134}

The Court referred back to \textit{Gilly} and \textit{Saint-Gobain} when it stated that the Member States are free to, between themselves, determine the connecting factors when it comes to allocation of the powers of taxation but the exercise of that power must be done in compliance with Community rules. The rules such as those in issue were thus held to constitute an obstacle to the freedom of movement of workers, prohibited by Article 39 EC.\textsuperscript{135}

Possible justifications were raised, the first being that the disadvantage suffered by the taxpayer was largely compensated by a progressivity advantage. This was, as in earlier cases, denied, since it was held that a disadvantage serious enough to be in breach of the fundamental freedoms could not be “cancelled out” by another advantage.\textsuperscript{136}

Secondly, the Netherlands Government argued that it was legitimate for the residence state to only take into account personal and family circumstances as far as was proportionate to the income derived in its territory, since it was for the source state to do the same with respect to the share of income taxable in its territory. The Court rejected this argument, referring to the OECD Model when stating that the taking into account of a taxpayer’s personal and family circumstances was, in principle, a matter for the residence state and that a non-resident’s ability to pay taxes is most easily assessed at the place where his personal and financial interests are centred.\textsuperscript{137} Moreover, the residence state can be released from

\textsuperscript{131} As described by the Hoge Raad der Nederlanden in C-385/00 \textit{F.W.L. de Groot v Staatssecretaris van Financiën} [2002] ECR I-11819, para. 36.

\textsuperscript{132} C-385/00 \textit{F.W.L. de Groot v Staatssecretaris van Financiën} [2002] ECR I-11819, para. 46.

\textsuperscript{133} \textit{Ibid}, para. 81.

\textsuperscript{134} \textit{Ibid}, paras. 83-84.

\textsuperscript{135} \textit{Ibid}, para. 93-95.

\textsuperscript{136} \textit{Ibid}, para. 97.

\textsuperscript{137} \textit{Ibid}, para. 98.
this obligation to take into account in full the personal and family circumstances of resident taxpayers who work partially abroad. For example, this could happen through international agreements \(^{138}\) or if the residence state finds that those personal and family circumstances are taken into account in the source state and advantages based on those circumstances are granted there \(^{139}\). The Court concluded that, irrespective of how the Member States allocate the obligations between themselves, taxpayers who exercise their right to freedom of movement for works must be certain that all their personal and family circumstances are taken into account. \(^{140}\) In the case at hand, that result was not ensured. \(^{141}\)

Other possible justifications were brought forward, based on the loss of tax revenue \(^{142}\) and safeguarding of the cohesion of the method of exemption with progression \(^{143}\). Both of these were denied.

Therefore, the answer to the first question posed by the national court was that Article 39 EC did preclude rules such as those in issue in the main proceedings. \(^{144}\)

### 2.4.4.3 Requirements in EC law regarding personal circumstances of workers

The second question posed by the national court was whether or not Community law contains any special requirements with regard to the way in which the residence state must take into account the personal and family circumstances of an employee who has worked in another Member State. \(^{145}\)

The answer from the ECJ was short and to the point. Community law laid down no such special requirements, except that the conditions governing how the residence state takes those circumstances into account must not constitute discrimination, direct or indirect, on grounds of nationality, or an obstacle to the exercise of the fundamental freedoms. \(^{146}\)

### 2.4.4 Comments

The ruling in the *de Groot* case can be said to be another example of how the ECJ is prepared to preclude the application of tax treaty provisions that are in breach of Community law. However, The Court will only take such an action when doing so will not have a significant negative impact on the overall tax treaty network.

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\(^{139}\) *Ibid.*, para. 100.


\(^{142}\) *Ibid.*, para. 103.


\(^{144}\) *Ibid.*, para 110.

\(^{145}\) *Ibid.*, para. 112.

The main method of exemption with progression can be found in the OECD Model; the *pro rata parte* method, however, is not present.\(^{147}\) The provisions in question were thus not directly based on the OECD Model, and could be declared as being non-compatible with free movement law without unwanted repercussions for many of the other tax treaties that have been concluded between Member States. In such cases, the Court will treat the provision in the same way as it would a unilateral tax provision in one Member State.\(^{148}\)

Of interest is also that the Court once again made special mention of the OECD Model, referring to it in order to reject a possible justification brought forward by the Netherlands government,\(^{149}\) signalling recognition of its significance in the field of tax treaty law.

### 2.5 Summary

Even though the main focus of this thesis is on the relationship between tax treaties and EC law, it is the authors’ belief that some basic knowledge of the principles that have emerged in cases dealing with Member States’ income tax legislation is necessary to facilitate a better understanding of the discussion with regard to tax treaties. Therefore, this chapter has dealt with the development of both the field of direct tax law and the field of tax treaty law, as they relate to EC law. The “evolution” of direct tax law in a Community context has primarily taken place through the case law of the ECJ, with the first case dealing with direct taxes often said to be *Avoir fiscal*.

At first, it was believed that the Member States retained exclusive sovereignty in the field of direct taxation. While it is technically true that Member States are free to legislate in this area, ECJ case law has shown that they must exercise those powers consistently with Community law. Effectively, this means that any tax legislation affecting cross-border situations is subject to scrutiny by the ECJ in order to ascertain that it complies with the Community rules on free movement and non-discrimination.

Some basic principles have been established in the case law of the Court when it comes to direct tax matters. Among the most important of these principles is the so called Schumacker doctrine, i.e. the non-comparability of residents and non-residents vis-à-vis income tax. Of significance are also the various grounds of justification that are specific to direct tax cases, those that have been accepted as well as those that have been rejected.

Even though much of the development has taken place in case law, there are a number of directives harmonizing areas of direct taxation within the EU. Foremost among these directives are the Parents-Subsidiary directive, the Mergers directive, the Interests and Royalties directive and the Savings Interest directive. The direct tax directive on Mutual Assistance is another very important piece of legislation in this field, which is shown not least by the large amount of ECJ cases in which the directive has been referred to by the Court.

Moving on to tax treaties and EC law, three cases have been commented on in detail: *Gilly*, *Saint-Gobain* and *de Groot*. A number of interesting principles on the relationship between the two areas of law can be extracted from these cases.

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147 While the *pro rata parte* method (as provided for in Dutch law) is not present in the OECD Model, paragraph 37 of the Commentary on Articles 23A and 23B provides for a method known as “alternative exemption”, which bears some resemblance to the *pro rata parte* method.


One such principle, first introduced in the *Gilly* case and then later added to in the *Saint-Gobain* case, is that tax treaty rules which deal only with the allocation of tax jurisdiction are neutral and cannot be discriminatory, even if there is a criterion based on nationality. However, the ECJ makes a distinction between the allocation and the exercise of taxation powers, where the latter must be done in a way that complies with Community rules.

The *Gilly* case was exceptional in that the ECJ in several respects diverged from established case law. This approach can be seen as a result of the Court’s unwillingness to deliver rulings that would negatively impact the tax treaty network within the EU. While the reasoning in *Saint-Gobain* was more in line with the case law, the same underlying motivation can be understood from reading that ruling, and it is reaffirmed once again in the *de Groot* case. It seems that declaring a tax treaty provision incompatible with EC law, when that provision is based on the OED Model and/or widely used in bilateral tax treaties between Member States, is a can of worms that the ECJ would rather not open. However, when the provision at hand is not as widely used or when the problem can be dealt with without disrupting the tax treaty network (for example by extending benefits unilaterally, as in *Saint-Gobain*), the ECJ has no problem with ruling that provision to be in breach of Community law.

As seen in this chapter, there are a number of problems related to tax treaties and their compliance with Community rules that have been put forward to the ECJ. Some of these problems will be discussed in greater detail in the next chapter, along with problems not yet put before the Court, as well as issues connected to the most-favoured-nation principle.
3 Problems

3.1 Introduction

This chapter will present and discuss provisions in tax treaties, and situations created by such provisions that could be found to be in breach of Community law with regard to the fundamental freedoms. The provisions discussed in this chapter will include both the type of provisions that have already been ruled upon in the case law of the ECJ and some types that could possibly be challenged in the future. The provisions that cause problems in regard to the four freedoms are very different in nature, scope and effect. This chapter will present possible problems relating to the rights of non-nationals to be treated no less favourably in a new Member State of establishment, of provisions in tax treaties deterring nationals of one Member State from exercising their right to establish themselves in another Member State and other provisions that could possibly be seen as obstacles to the free movement guaranteed by the EC Treaty. In this discussion a number of taxes will be presented briefly, for example trailing taxes and exit taxes. A number of principles and concepts will also be discussed, both from the case law of the ECJ and from international taxation in general. The presentation will include a number of provisions taken from tax treaties between Member States and the OECD Model Treaty will be used as a comparison.

The outline of this chapter is as follows: Firstly, the differences between the allocation and the exercise of taxation power will be discussed and a definition of both these concepts will be attempted. Then a number of provisions and rules from tax treaties of Member States and the problems that they have caused or may cause in relation to EC law will be presented. This will include a presentation on the questions put in front of and answered by the ECJ so far. Following that, there will be a presentation and discussion of the problems relating to the concept of most-favoured-nation treatment and the judgements of the ECJ to this date. Lastly, there will be a discussion on the economic and political implications that the ECJ have taken account of in its past judgements and the ways in which the Court has deviated from its own case law in its efforts to promote and protect the internal market.

3.2 Allocation of fiscal jurisdiction

3.2.1 Connecting factors and discrimination

Treaties for the avoidance of double taxation generally try to avoid double taxation through deciding what state has the primary right to tax a certain income or event. This is done both because states normally only tax income not connected to their national territory under certain circumstances and also because this is the most effective way of avoiding double taxation. Since there are many different ways to connect income to a state’s territory, almost any income with an international connection will run the risk of being taxed in more than one state. Therefore, the tax treaties will seek to avoid double taxation through giving exclusive or primary right to taxation to one of two states and to limit the rights to tax of the other state. The allocation of taxing rights will be based on a number of factors that will give the right to tax to the state most closely connected to the income in question. It will be shown in this chapter that there are many derogations from the rules on allocation in tax
treaties, but they will be presented where appropriate. The aim of this discussion is to show different connecting factors and to give an overview of the ECJ’s case law regarding the difference between allocation and exercise of taxation rights and also to try to present some provisions that are difficult to define as either allocation or exercise.

When deciding in what state an economic activity is carried out and what state is, or should be, allowed to use its taxation powers, a number of connecting factors need to be used. The same applies to any other taxable event or income that could be taxed in more than one state. These connecting factors are used both in tax treaties and national tax legislation and are in many cases based on the OECD Model Treaty. Connecting factors commonly used are residence, nationality and the place of economic activity. The use of these factors leads to a set of rules detailing which state has the primary right to tax an income and if the other contracting state has kept any residual rights to taxation. Examples from the Model is that income from immovable property will be taxed in the state where the property is situated, that dividends generally are taxed in a persons state of residence and that pensions normally are taxed in the state of residence of the receiver.

When put in a Community perspective these connecting factors may appear to be running the risk of being contrary to the absolute ban on discrimination based on nationality and the freedoms of movement. For example, the use of nationality to decide a number of important issues in national tax law could under certain circumstances be considered as direct discrimination based on nationality and the use of residence as a connecting factor could be regarded in many cases as indirect discrimination because such provisions could negatively affect non-nationals and put them in a less favourable position than nationals. In its case law the ECJ has established that discrimination arises when the same rules are applied to different situations or when different rules apply to comparable situations. The Court has also made it clear that indirect discrimination is caused when rules that use other criteria for differentiation lead to the same results as if they were based on nationality. This is the case when residents are treated differently from non-residents, as these forms of rules:

“...are liable to operate mainly to the detriment of nationals of other Member States. Non-residents are in the majority of cases foreigners.”

In the field of taxation, comparable situations can be hard to ascertain. When are residents and non-residents in a comparable situation in regards to taxation? That question is at the very heart of the case law of the ECJ as regards taxation. In the *Schumacker* case the ECJ stated that:

“In relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable.”

The Court goes on to state that the difference in treatment of residents and non-residents is a part of established international tax law and that this is mainly because it is up to the state of residence to take into account the personal and family situation of taxpayers in regard to their overall tax burden. The Court states that the fact that a Member State does not grant certain tax benefits to non-residents which it grants to residents cannot, as a rule,


152 Ibid, para. 28.

153 Ibid, para. 31.
be considered discriminatory. This is because they are not in general in comparable situations. In this judgment the Court decided that using residence to differentiate between taxpayers was acceptable as long as it does not result in indirect discrimination. As long as national tax legislation does not treat non-residents that are in a comparable situation with residents in a less favourable way, the use of residence as a connecting or differentiating factor is not contrary to the fundamental freedoms.

Regarding tax treaties the question of the admissibility of provisions based on nationality and residence is even more central, as the Model treaty used by most of the EU Member States when concluding tax treaties uses those factors to allocate taxation rights in almost all of the provisions. These issues were raised in the *Gilly* case, in which Mrs. Gilly argued that the use of the French-German tax treaty resulted in her being the object of unjustified, discriminatory and excessive taxation. She was a national of both France and Germany and she was employed as a school teacher in Germany but was resident in France. According to the treaty she was taxed in Germany according to the paying state principle, partly because of her German nationality. In its reasoning the Court stated that even though the criterion of nationality is used to allocate the fiscal jurisdiction, such differentiation cannot be regarded as constituting discrimination.154 According to the Court it is, in the absence of unifying or harmonizing measures from the Community, up to the Member States to decide the criteria for allocating their powers of taxation between them, when trying to eliminate double taxation.155 The Court goes on to state that it is not unreasonable for the Member States to base their agreements on international practice and the Model Treaty drawn up by the OECD; the rule of paying state being part of so many treaties between OECD and Member States that it can be said to be internationally accepted. In the later case *Saint-Gobain*156 the court reiterated its decision in *Gilly* and stated that;

"...in the absence of unifying or harmonising measures adopted in the Community, in particular under the second indent of Article 220 of the EC Treaty (now the second indent of Article 293 EC), the Member States remain competent to determine the criteria for taxation of income and wealth with a view to eliminating double taxation by means, inter alia, of international agreements. In this context, the Member States are at liberty, in the framework of bilateral agreements concluded in order to prevent double taxation, to determine the connecting factors for the purposes of allocating powers of taxation as between themselves..."157

The Court has argued in the same way in later case law158 and so it must now be clear that the Court will not find rules that only allocate the fiscal jurisdiction to be in breach of EC law in that they are discriminatory on the basis of nationality. It is also quite clear from this case law that the Court has found that rules that closely follow the OECD model have a certain gravitas, and only the future can tell if this will mean that the Court will give such rules a greater importance in judgments on double taxation.


155 Ibid, para. 30.


157 Ibid, para. 56.

158 C-327/03 *D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen* [2005] ECR I-528, para. 52.
3.2.2 Allocation or exercise?

3.2.2.1 Introduction
Making a distinction between allocation and exercise of taxation rights might not seem too complicated on a theoretical level, but provisions must be examined not only by their linguistic content but also by the intent behind the provisions. In short, the distributive rules decide if and to what extent an income in a cross border situation may be taxed in either, or only be taxable in, the state of source or state of residence. Rules that decide how that competence to tax is used are connected to the exercise of taxation rights. Distributive rules have in common that the contracting states mutually decide who will have the primary right to taxation and also if the other state has the right to impose a withholding tax, also called taxation at source. There are those that are of the opinion that provisions on withholding taxes are allocation rules, but the authors’ views are that these provisions are not so easily categorized. Withholding taxes are in this thesis defined as any tax a state of source may impose on an income paid from that state to a receiver in another state. The functioning and the ambit of such rules must be examined to decide if they are rules of allocation or exercise.

When trying to decide on these issues there are three main types of rules present: the rules that are clearly allocation rules, those that are clearly rules on exercise of taxation power and lastly those that are somewhere in between, which need to be decided on a case to case basis. With the help of provisions from the OECD Model treaty, examples will be given of the first and last of these categories, since there will be problems finding rules in the Model treaty that are clearly related to exercise of taxation rights. Therefore such rules will be discussed with reference to case law and certain provisions in treaties designed to calculate profits.

3.2.2.2 Purely allocation
Article 6 of the Model treaty is an allocation provision. Its only purpose is to allocate the right to tax income from immovable property and to define what that property is. According to the case law of the ECJ a provision in a tax treaty that is based on this article and does not divert far from it will not be in jeopardy of being found contrary to the free movement provisions of the EC Treaty.

“INCOME FROM IMMOVABLE PROPERTY

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.”

3.2.2.3 Both allocation and exercise
Article 10 starts out with a provision that serves to allocate the right to tax dividends. It clearly states that the primary right to tax lies with the state in which the receiver of the dividends is resident;

“DIVIDENDS

159 Hilling, M, Free movement and tax treaties in the internal market, p. 289.
160 Article 6 of the OECD Model treaty.
Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State." 161

However, in the second part, the article states that the state where the dividend is paid from has the right to tax the dividend to a certain extent.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

b) 15 per cent of the gross amount of the dividends in all other cases.

As the former part already has allocated the right to tax, it must be argued that this rule, providing a way for states to impose a withholding tax, is an exercise of that right to tax. This is mainly because the rules allowing withholding taxes go beyond what is meant by allocation of taxation rights. Withholding taxes are not used to abolish double taxation, they are a means for states to make certain that they do not lose too much of their tax revenue. Even though it could be argued that this provision allocates part of the right to tax between the states, it still is a provision on the exercise of taxation power since it decides how income shall be taxed and not by whom it is to be taxed. It should also be mentioned that the intentions behind this form of provisions is not the same as those behind the provisions on allocation. Where allocation rules are meant to alleviate double taxation; rules on withholding taxes are meant to protect the national tax base.

3.2.2.4 Purely exercise

There are quite few rules in tax treaties that determine how a state shall exercise their right to taxation. This is probably because it is not the aim of tax treaties to determine how income shall be taxed. The main aim of tax treaties is to decide who has the primary or exclusive right to taxation. Even so, there are provisions in tax treaties regarding the exercise of taxation rights. Van Thiel gives some examples of such provisions. 162 There are rules on how the source state shall determine the profits of a permanent establishment or a fixed base. 163 Van Thiel also mentions that rules on exemption with progression or direct foreign tax credit can be rules on exercise, but also that it could be argued that such provisions are rules on allocation of taxation rights. 164

In our view there is a good example of a provision on exercise of taxation rights in the later case law of the ECJ. In the D 165 case one of the questions is of a provision in the treaty be-

161 Article 10, first indent, of the OECD Model treaty.
164 Ibid, p. 516.
165 C-327/03 D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen [2005] ECR I-5281.
tween the Netherlands and Belgium regarding the right to personal allowances, concessions and reductions of the burden of tax of residents of the one state in the other state. Such allowances shall be given irrespective of where a person has its residence. Such a rule must be said to be concerned with the exercise of taxation rights only. It does nothing to allocate any rights to tax and its only function is to put the states under an obligation to give allowances and similar without regard taken to where a person is resident.

3.3 General problems

3.3.1 Problems put before the ECJ

3.3.1.1 Introduction

This part of the chapter will discuss some of the problems brought on by tax treaties that have been put before the ECJ for preliminary rulings. Since these cases have been presented in detail already, only the specific problems will be presented and discussed. Problems of rules of allocation have been found in almost all cases before the Court and have been discussed above and will therefore not be a part of this chapter in any greater detail.

3.3.1.2 Method provisions

Articles 23A and 23B of the OECD Model treaty contains two basic methods for eliminating double taxation, namely the exemption method and the credit method. The credit method means that the state of residence does not limit its right to tax its residents. The world wide income is used to calculate the tax due, a credit is then given for the tax already paid in the state of source.

In the Gilly case the applicants claimed that the fact that Mrs. Gilly had a higher tax burden from her frontier work than she would have if she had worked in France where she was a resident was contrary to the freedom of movement for workers. The treaty between France and Germany used a credit method and because of the higher progressivity and general tax level of Germany, that credit did not amount to all the tax paid in Germany. Mrs. Gilly claimed that the use of the treaty had led to unjustified, discriminatory and excessive taxation of her income.

In its answer the Court started out by stating that the purpose of tax treaties is to prevent the same income from being taxed in two or more states, not to make certain that income is taxed at the same level as in the other contracting state. The ECJ went on to state that any unfavorable consequences arising in this respect is caused by the different scale of the taxes in the Member States and that in the absence of any harmonization, those scales are determined by the Member States themselves. Oddly enough, the loss of tax revenue was mentioned as a sort of justification, even though the Court itself had clearly stated that the loss of revenue argument is not a justification for breaches of Community law.

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166 Ibid, para. 13.
168 Ibid, para 46.
169 Ibid, para. 47.
170 Ibid, para. 48.
The judgment has been criticized\(^{171}\) and it is true that the reasoning of the Court can be seen as somewhat unusual. Instead of basing the decision on the effect of the rules, the Court takes a decision based on the intention and objectives of the provisions. This is unusual since the Court will normally see to the effect of rules challenged before it and then base its decision on whether or not that effect gives rise to discrimination. Had the Court argued in its ordinary way, there is a good chance that the outcome had been different. This is mainly because it clearly makes it less attractive to work in another state if it leads to a heavier taxation, and such discouraging effects are not supposed to exist within the European Community. The reasoning of the Court in this case will also be discussed in a later chapter, but right now it seems like situations such as this will not be considered as contrary to EC law by the Court.

### 3.3.1.3 Permanent establishments

In basic international tax treaty law permanent establishment are not considered to be covered by such treaties. The OECD Model states that it applies to persons that are residents of one or both of the contracting states.\(^{172}\) The definition of a resident in Art. 4 does not cover PEs and therefore they are not considered residents in any of the states when it comes to being allowed benefits found in the Model Treaty. Since the rules on freedom of establishment and case law from the ECJ makes it clear that companies shall be free to choose the form of establishment that is most suitable for their business in another Member State, it must be a breach of EC law to have such provisions in a treaty between Member State, as could have a detrimental effect on the free movement, since a PE in the form of a branch in many cases is the easiest and quickest way to establish oneself in a new state and on a new market.

In the case *Saint-Gobain*\(^{173}\) the ECJ was asked by the national court if the EC Treaty prohibited Germany from excluding PEs by companies from other Member States from the scope of certain tax relief systems connected to income from dividends under a number of tax treaties. The Court first stated that permanent establishments in the form of branches and companies set up under the German law are treated differently in regards to this certain tax relief. This difference in treatment makes it less attractive to set up a business in the form of a branch. The Court states that the difference in treatment and the restriction on the freedom to choose form of establishment was a breach of Art. 52 and Art. 58 EC.\(^{174}\) The German government claimed that the difference in treatment was justified by the fact that PEs are not in a comparable situation with resident companies. The Court answered this by deciding that in this certain area of taxation, with the exception of the tax relief, PEs were treated by German law in the same way as resident companies and that this together with other factors meant that the two forms of business were in a comparable situation and that the difference in treatment was not justifiable.

Even though the judgment states the condition under which the ruling is given, it can be used to assess other situations. If a PE of a Member State in another Member State is found

\(^{171}\) Hilling, M, Free movement and tax treaties in the internal market, p. 258.

\(^{172}\) Article 1 of the OECD Model treaty.


\(^{174}\) Ibid, para. 43.
to be in a comparable situation as a resident company as regards a certain form of taxation, it is to be made subject to tax treaty provisions in that field of taxation.

3.3.2 Problems not put before the ECJ

3.3.2.1 Introduction

This part of the chapter will present possible future problems that could be challenged in front of the ECJ. The first problem is trailing taxes and the second the exclusion of persons from the scope of a tax treaty. Even though exit taxes are often mentioned as a possible solution instead of trailing taxes, they will not be discussed here to any greater extent. This is mainly because any such provisions will not generally be part of a tax treaty, but rather a part of the national tax legislation.

3.3.2.2 Trailing taxes

When residents leave a state to become resident in another state they generally transfer their property along to that new state of residence. From the view of the old state of residence this will be a loss of tax revenue since normally gains on property will be taxed when the property is sold or alienated in any way. A move to another state can be for personal or professional reasons, but it can also be done to avoid paying tax in the first state of residence. Provisions that try to handle this situation can be seen as preventing tax evasion, but they will also affect residents that are moving for other reasons. This means that the rules are put into place for good reasons, but they have a tendency to hit blindly at persons moving for any reason.

The most common rules used for trying to control this situation are trailing taxes and exit taxes. Exit taxes will not be discussed here in greater detail as mentioned above, but they function in the way that they treat the move from one state to another as a taxable event and therefore tax the property of the person moving using an approximated value on the property leaving the state. Trailing taxes are a less invasive way of taxing persons who are moving from one state to another. The trailing taxes will most often be part of tax treaties even though they do not seem to be very common. Trailing taxes can be either specific or general, in that they either target a specific form of property or any property owned by a person that leaves his state of residence. The tax normally means that the old state of residence keeps a right to tax certain sales of property that are done within a specified number of years in the new state of residence. This right to taxation is not affected by the right that the new state of residence has to tax the same income. A good example of a trailing tax provision is found in the Swedish-Polish tax treaty. Article 13 of that treaty regulates the sale of property. The first part of the Article regulates the special rules for the sales of immovable property, business property and ships or aircrafts. Any other property sold by a person who has moved from one contracting state to the other runs the risk of being liable to pay tax in his old state of residence if it is done within ten years of moving:

"Notwithstanding the provisions of paragraph (4), gains from the alienation of any property derived by an individual who has been a resident of a contracting state and who has become a resident of the other contracting state, may be taxed in the first-mentioned state if the alienation of the

\[175\] Avtal med Polen för undvikande av dubbelbeskattning och förhindrande av skatteflykt beträffande skatter på inkomst, SFS 2005:248.
property occurs at any time during the ten years next following the date on which the individual has ceased to be a resident of the first-mentioned state."

It should be mentioned that national Swedish taxation legislation limits property that can be taxed in such a way to participations in Swedish limited liability company, partnerships, co-operatives societies and a number of rights and derivatives connected to such participations.\(^{177}\)

The use of a trailing tax will create a risk of double taxation because both the old and the new residence state have a right to tax the same income. Normally, the residence state has the obligation to avoid double taxation, but in this case it is hard to decide which state should have the obligation to make sure that the taxpayer is not taxed on the same income in more than one state. The most logical solution to this problem would be to give the old state of residence the obligation to avoid double taxation in these cases, since the deviation from the normal rules on this sort of income is done for the benefit of that state. The trailing tax is put into place on behalf of the old state of residence, with the aim of stopping tax avoidance and to protect the tax base of that state, therefore that state should be responsible to make sure that double taxation is avoided. Hilling states that since the OECD model provides a solution to the taxation of capital gains, if any Member State deviates from that solution it should be responsible for avoiding double taxation caused by that deviation.\(^{178}\)

Another way of finding out which state should be responsible for avoiding double taxation in a situation like this is to decide which state has the better right to tax. This is not always an easy exercise, but in this case it is the authors’ view that the better right to tax is with the new state of residence since it is normally the state that can tax such an income, and only in a very limited number of cases, when the move to a new state is actually done to escape taxation in the old state of residence, the better right to tax is retained by the old state of residence. It is worth noting that in the Swedish-Polish tax treaty the mentioned double taxation is avoided first by Sweden giving a credit for the amount that can be taxed in Poland, and in the other case by Poland applying an exemption on the income that can be taxed in Sweden.\(^{179}\)

When trying to decide if trailing taxes, provided for in provisions of tax treaties concluded between Member States, would be allowed by the ECJ, there are a number of important issues to address. The first thing that must be decided is if the provisions on trailing taxes are rules on allocation or exercise of taxation powers. If they are found to be rules on allocation they would probably be allowed by the ECJ without closer scrutiny, according to its own case law.\(^{180}\) Provisions on allocation of taxation power have in common that they are neutral rules that simply state which state has the primary taxation right. This rule cannot be said to be such a rule. It deviates from the “normal” rules on allocation in these matters and also has a different motive and function from other rules on allocation. The rule is used to protect the Swedish tax base, but this means that this rule has a function that not

\(^{176}\) Avtal med Polen för undvikande av dubbelbeskattning och förhindrande av skatteflykt beträffande skatter på inkomst, SFS 2005:248 , article 13(5).

\(^{177}\) Inkomstskattelagen (1999:1229) (Swedish income tax act) chapter 3 section 19.

\(^{178}\) Hilling, M, Free movement and tax treaties in the internal market, p. 296.

\(^{179}\) Avtal med Polen för undvikande av dubbelbeskattning och förhindrande av skatteflykt beträffande skatter på inkomst, SFS 2005:248, article 22. 2. (a).

only distributes but also one of exercising taxation rights, since it goes beyond a neutral allocation of taxation rights.\textsuperscript{181}

It must be examined if a trailing tax can be said to be in breach of any of the fundamental freedoms. The freedom most likely to be at issue here is the freedom of establishment\textsuperscript{182}, since it is a question of a national of one Member State who is trying to establish in another Member State. The trailing tax provided for in the Swedish-Polish tax treaty is not dependent on the person moving being a national of the first state. This does not mean that it could not be found to be discriminatory in its application. The Court has stated that:

“… provisions which preclude or deter a national of a Member State from leaving his country of origin to exercise his right to freedom of movement therefore constitute an obstacle to that freedom even if they apply without regard to the nationality of the worker concerned.”\textsuperscript{183}

The same applies to all the freedoms and this means that provisions such the one at hand can be found to be discriminatory even though it does not mention or differentiate on the grounds of nationality. It is therefore necessary to decide if the provisions on trailing taxes could deter a person from moving to another Member State. The ECJ has in its case law explained that deterrents to the exercise of freedoms does not have to be a factual present hindrance, a possible future deterrent is enough for a provision to be unlawful.\textsuperscript{184} A possible double taxation can clearly be a deterrent to person who would like to move from one Member State to another. Whether the ECJ would give a judgment to that effect, if the question came before it, is harder to answer. The Court has taken into account a number of factors when ruling on questions related to double taxation, some which are not possible to read in the treaty or other acts of EC law. The ECJ will take into account for example the political situation in the Union and also how the Member States have concluded their different tax treaties. If the Court sees that a judgment declaring trailing taxes to be contrary to EC law would have a large impact on the tax treaty network it might be more lenient in its judgment, since it is in the interest of a effective inner market that the Member States have tax treaties with each other and the ECJ would not want to do anything to discourage the Member States from concluding such treaties. However, for the further discussion it will be assumed that the ECJ would find the use of trailing taxes leading to possible double taxation to be in breach of EC law.

The next step would be to find possible justifications for the use of trailing taxes. There are treaty justifications connected to the freedom of establishment found in Article 46 EC. These are: public policy, public security and public health, and have, to our knowledge, not been invoked successfully to justify any tax measures. Successful justification of tax provisions would instead be based on an imperative interest. Imperative interests or overriding requirement of general interest capable of justifying a restriction on the exercise of fundamental freedoms guaranteed by the EC Treaty are not found in the treaty itself and they can only justify restrictions that are not directly discriminatory. Examples of imperative interests are the effectiveness of fiscal supervision\textsuperscript{185}, prevention of tax avoidance\textsuperscript{186} and pre-

\textsuperscript{181} Hilling, M, Free movement and tax treaties in the internal market, p. 297.

\textsuperscript{182} Art. 43 EC.

\textsuperscript{183} C-385/00 F.W.L. de Groot v Staatssecretaris van Financiën [2002] ECR I-11819, para. 78.


venting companies from benefiting twice from rules on deductions.\textsuperscript{187} It should be noted that the loss of tax revenue is never an imperative interest.\textsuperscript{188} Another important fact to remember is that even though a measure might be justifiable because of an imperative interest, it will still have to be proportional and be necessary to attain the aims of the rule.\textsuperscript{189} Since trailing taxes are not by their nature directly discriminatory, they could possibly be justified by imperative interests. Because of the functioning of trailing taxes, the most likely imperative interest to be used in trying to justify trailing taxes would be the prevention of tax avoidance.\textsuperscript{190} Any provision trying to rely on the prevention of tax avoidance will have to apply in the least restrictive way possible and be precise enough to only affect purely artificial arrangements.\textsuperscript{191} Purely artificial arrangements are in this case defined as transactions, or other actions taken, that are done only to avoid taxation and having no other reason for being performed. Trailing taxes, as defined in this chapter, will not have only affect purely artificial arrangements as they will possibly affect any person moving from a state that has concluded tax treaties including trailing taxes. The aim of trailing taxes is to protect the tax revenue of the state, which is the main reason why they would be very hard to justify, since the loss of tax revenue is not an imperative interest.

The conclusion to all this is that even though trailing taxes are liable to be in breach of the EC rules on the freedom of establishment, it is unclear if the ECJ would go so far as to say that they are contrary to EC law. This mainly because of the possible political drawbacks it could have on the conclusion of tax treaties and also the taking into consideration of the welfare of the internal market and which course of action would be the most positive for it.

3.3.2.3 Limitations of benefits

Companies will always be interested in reducing their tax burden, and tax treaties are a way of doing so. Being based in a state with favourable provisions in their tax treaties can make a big difference to a company’s profit. Because of this there is a very real threat that companies will try to take advantage of tax treaties through transactions created only to do so. The way in which states try to hinder these sorts of actions is normally by trying to make sure that the treaties are not applicable to any transaction taken exclusively to take advantage of a treaty. One way of taking advantage of treaties in this way is to use a conduit company. There are many definitions of a conduit company, but here it is defined as a company set up in a state by another company or person to take advantage of a tax treaty that the company or person would otherwise not be part of. For example a company in state A will set up a company in state B to receive dividends from a company in state C. The company in state B then pays the money to the company in state A, most often through dividends, but it can be possible to pay it as interest if there are loans between the companies or as a royalty payment or similar. This would be to take advantage of advantageous tax treaties between state B and state A or C or both. Behavior like this can in the

\textsuperscript{186} Case C-446/03 \textit{Marks \& Spencer plc v David Halsey (Her Majesty’s Inspector of Taxes)} [2005] ECR I-10837, para. 49-50.

\textsuperscript{187} \textit{Ibid}, para. 47.

\textsuperscript{188} C-319/02 \textit{Petri Manninen} [2004] ECR I-7477, para. 49.

\textsuperscript{189} C-250/95 \textit{Futura Participations SA and Singer v Administration des contributions} [1997] ECR I-02471, para. 36.

\textsuperscript{190} Hilling, M, Free movement and tax treaties in the internal market, p. 297.

\textsuperscript{191} C-264796 \textit{Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes)} [1998] ECR I-04695, para. 26.
long run harm the use of tax treaties since they can damage the balance of bilateral agreements. Here possible solutions to the problems with conduit companies will be presented and discussed, since it is interesting from an EC law perspective, especially from the view of the free movements enshrined in the EC Treaty.

The OECD is very aware of this situation and has in the Commentary given examples of how the problem could be rectified. The recommendations from the OECD are found in the commentary on article 1.192 The first solution presented is to disallow treaty benefits to a company not owned, directly or indirectly, by residents of the state of which the company is a resident.193 This sort of provision is commonly known as a limitation of benefits clause and an example is given in the commentary to how a provision based on this thinking could be worded:

“A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State.”

The paragraph then goes on to state that it might be necessary for states using this form of rules to define “owned or controlled” and to take into consideration if bona fide business activities are affected by such rules. If Member States would have rules like this in their tax treaties it would be in breach of EC law since subsidiaries of companies from other Member States would be treated less favorably than subsidiaries of companies resident in that state. Possible justifications will be discussed later in this chapter. The next possible solution according to the commentary is a “subject to tax” provision.195 Its function would be to make sure that any companies not owned or controlled from its residence state will only be granted exemptions or relief from tax in one contracting state if it is subject to tax in the other contracting state under normal company taxation rules.196 It is recommended that the provision is supplemented by rules regarding bona fide business activity. The third solution presented is a so called channel approach. The same definition of companies affected as in the second solution is used. Such a company would not be entitled to exemptions or reductions of tax if more than 50% of its income is used to satisfy claims of its non-resident owners.197 The commentary then states a number of provisions that can be used to ensure that this sort of exclusion from treaty benefits does not affect bona fide business activity.198

The first is a general provision stating that a company shall not be excluded from benefits if it can prove that the principal purpose of the company is motivated by sound business reasons and that the company does not have as its primary purpose to obtain benefits under a tax treaty. Secondly, it is recommended that a company shall not be excluded from benefits if it is involved in substantive business operations in its residence state, and the relief from taxation claimed is connected to those operations. The third provision is that a

192 OECD Commentary on article 1, part C.2.
194 Ibid, para. 13.
195 Ibid, para. 15.
196 Ibid, para. 15.
197 Ibid, para. 17.
198 Ibid, para. 19.
company shall not be excluded from benefits if the reduction of tax claimed is not greater than the tax actually imposed by the contracting state where the company is a resident. The fourth recommendation is that a company shall not be excluded from benefits if its principal class of shares is registered on an approved stock exchange in a contracting state, or if it is wholly owned, directly or indirectly, by a company which is registered in such a way. The fifth is an alternative relief provision and it states that residents from third states shall not be seen as non-residents if their state of residence has in effect a tax treaty with the contracting state from which relief from taxation is claimed and that treaty provides not less relief from tax than the treaty between the two contracting states. The Commentary then gives an example of how a provision that is built on these different rules can be formulated. 199

Provisions limiting the scope of a tax treaty as regards companies owned by persons or companies not resident in the same state can create problems when it comes to EC law. Member States are under an obligation to treat companies owned by nationals of other Member States in the same way as companies owned by its own nationals. 200 At the outset it must be quite clear that provisions such as those presented above on excluding companies based on their ownership will mean that companies owned by residents of other Member States will be given a less preferential treatment than companies owned by residents of the state in question. The discrimination is not direct, but as most non-residents also are non-nationals, it will indirectly discriminate against nationals of other Member States. The treaty must not be between Member States to be discriminatory as the provisions in treaties with third states will affect companies from other Member States if they are caught by the definition of a company owned by non-residents. This sort of discrimination through bilateral agreements was under scrutiny in the Open Skies 201 cases. The ECJ stated that since companies owned by persons from other Member States can be excluded from benefits that companies owned by nationals of the same state can enjoy, they are subject to discrimination. 202 The Court also states that the discrimination comes from the agreement itself and therefore that the conclusion and application of the agreement was a breach of EC law. 203

Thus, excluding companies owned by persons from other Member states from enjoying benefits granted to companies owned by its own nationals will imply a breach of EC law. It must then be examined if such a breach can be justified. Using the treaty justifications of public policy, public security or public health 204 have never been successful in tax cases. Instead any defense of provisions like this will have to be based on imperative interests. 205 In this case the most likely reason to be used as a justification is the prevention of abuse of tax

199 Ibid, para. 20.

200 Article 43 EC.

201 Since there were a number of judgments delivered on the same subject on the same day, the case C-466/98 Commission of the European Communities v United Kingdom of Great Britain and Northern Ireland [2002] ECR I-9427 will be used for reference.


203 Ibid, paras. 51-52.

204 Article 46 EC.

205 Imperative interest used in tax case are presented in 3.3.2.2.
treaties. Any rules regarding such abuse will have to be directed towards wholly artificial situations to be justified. As seen from above there are a number of ways in which contracting states can try to make sure that only wholly artificial situations are affected. Any rules regarding exclusion from benefits of a treaty would have to be very specific and include exceptions from the main rules to be even reasonably safe from challenge under Article 43 EC. It is therefore justified to say that provisions on the exclusion from benefits in tax treaties between Member States or between Member States and third states should include either no provisions at all or very specific provisions on this subject. Such provisions should be carefully drafted so that they only affect cases of abuse and never companies that have proper business reasons to be established in a contracting state.

Another important matter to note is if the ECJ takes into consideration the fact that provisions on exclusion from benefits found in tax treaties would normally be based on recommendations from the OECD. The earlier case law of the ECJ can be interpreted in such a way that the Court will be less inclined to disqualify rules that are based on the work of the OECD. That view is probably based on the fact that the rules that have been under scrutiny have been rules that play a fundamental part in the treaties based on the OECD Model. If the Court had disqualified those rules it would have serious consequences on tax treaties in the whole of the EU. In this case though, the exclusion from benefits is not fundamental to the functioning of the treaties themselves and therefore the ECJ would probably rule on them without taking into consideration the source of the inspiration of the provisions.

### 3.4 The MFN principle, tax treaties and EC law

#### 3.4.1 About the principle

The most-favoured-nation principle is primarily a concept found in international trade law. While there is not one absolute definition of the concept, the essential core of it is the following: if a state grants another state a special benefit or advantage, and is obliged to give MFN treatment to a third state, that third state must also be granted the benefit or advantage. When as a trade concession is made, that concession must be unconditionally extended to all others who are part of the MFN agreement. In this manner, a bilateral provision becomes multilateralized. The name of the principle is somewhat misleading, as it suggests special treatment. What it really signifies is non-discrimination; treating all trading partners equally.

The MFN principle can be found, albeit in slightly different forms, in the three agreements that cover the main areas of trade handled by the World Trade Organisation (WTO): the General Agreement on Trade and Tariffs (GATT), the General Agreement on Trade in Services (GATS) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

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206 Hilling, M, Free movement and tax treaties in the internal market, p. 304.


209 Ibid.
As regards tax treaties, there are treaties in which MFN clauses can be found. There are also bilateral tax treaties which explicitly exclude MFN treatment. There is no explicit reference to the principle in the EC Treaty but, with the “evolution” of direct tax law as it relates to EC law being spearheaded by the ECJ, the question arose if the EC Treaty requires the MFN principle to be applied to double taxation treaties concluded between EU Member States. Voices were raised advocating different opinions on whether or not there was a legal basis for applying the MFN principle. According to van der Linde, these opinions can be divided into two camps: the Believers and the Unbelievers. The Believers argue from the principle that there is one EU, that citizens of the Member States are first and foremost citizens of the Union and emphasise the importance of a level playing field within the EU. The Unbelievers in turn point to the many unforeseen and unwanted consequences the application of the MFN principle could have on the tax treaty network within the Union, undermining the Member States’ sovereignty and eroding the tax profits.

Many looked toward the ECJ for guidance on this matter and great expectations were raised when a case finally arrived that looked as if it could make it possible for the Court to take a stand: the D case.

### 3.4.2 The D case

#### 3.4.2.1 Background

The D case is a very interesting piece of ECJ case law with regard to tax treaties and the MFN principle. It was thought that the Court would either circumvent the issue by settling the case on the basis of the national treatment approach or continue on the route it had started with regard to direct taxation and tax treaties, and apply the MFN principle. When the ruling arrived, many were very surprised at the outcome and the reasoning of the Court.

Firstly, the facts of the case: Mr D. was a resident of Germany, where he held 90% of his wealth. The remaining 10% consisted of real property situated in the Netherlands, where he was therefore liable to pay wealth tax. Dutch tax law provided for a tax-free allowance for resident taxpayers, as well as for non-resident taxpayers who held at least 90% of their wealth in the Netherlands. Mr. D. applied for this allowance, but was denied because he was not a resident of the Netherlands.

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212 Case C-376/03 D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen [2005] ECR I-5821.


214 Case C-376/03 D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen [2005] ECR I-5821, para. 15.

215 Ibid, paras 7 and 9.

216 Ibid, para. 13.
even though he was not a Dutch or Belgian resident, nor did he hold 90% of his wealth in the Netherlands. When his application was denied, he brought action against the decision.\textsuperscript{217} The national court referred the matter to the ECJ, in the form of three questions.

The first question concerned if EC law precluded the domestic legislation in question, where a resident taxpayer was always entitled to deduction of tax allowance in respect of wealth tax, whereas a non-resident was only entitled to it if most of his assets were situated in the state which granted the allowance.\textsuperscript{218}

The second question concerned if Community law precluded denying a non-resident the allowance, when provisions in a tax treaty granted the allowance to residents of the contracting state, which for all intents and purposes were in a situation analogous to the non-resident of the third state.\textsuperscript{219}

There was also a third question that concerned legal schemes on the reimbursement of costs in legal proceedings\textsuperscript{220}, but because of the answers given to the first two questions, the Court did not deem it necessary to deal with that issue.\textsuperscript{221}

\subsection*{3.4.2.2 Compatibility of Articles 56 EC and 58 EC with the denying of tax allowances to non-resident taxpayers, when they are granted to resident taxpayers}

The ECJ began by establishing that investment in real estate constituted capital movement and the question at hand therefore fell within the scope of the free movement of capital, laid down in Article 56 EC.\textsuperscript{222} The prohibition of restrictions on the movement of capital in Article 56 EC is in turn subject to Article 58 EC. Member States may, under Article 58 EC, in their tax law distinguish between resident and non-resident, as long as that distinction cannot be considered a means of arbitrary discrimination or a disguised restriction on the free movement of capital.\textsuperscript{223}

Further, the ECJ concluded that the situations of resident taxpayers and non-residents taxpayers are not as a rule comparable. This conclusion was based on past case law, in particular \textit{Schumacker}.\textsuperscript{224} However, this is not always the case. When a non-resident receives no significant income in his state of residence and the major part of his taxable income is received as a result of activities in the state of employment, there is no objective different between that non-resident and a resident, at least not enough to justify different treatment for tax purposes in the state of employment.\textsuperscript{225} Because of this, the Court has allowed Member

\begin{thebibliography}{99}
\bibitem{217} Ibid, paras. 16-17.
\bibitem{218} Ibid, para. 19.
\bibitem{219} Ibid, para. 19.
\bibitem{220} Ibid, para. 19.
\bibitem{221} Ibid, para. 64.
\bibitem{222} Ibid, para. 24.
\bibitem{223} Ibid, para. 25.
\bibitem{224} Ibid, paras. 26-28.
\bibitem{225} Ibid, para. 29.
\end{thebibliography}
States to make the granting of benefits to non-resident subject to the condition that at least 90% of his worldwide income is subject to tax in that state.\textsuperscript{226}

It is important to bear in mind that the case law on this subject concerned income tax and not wealth tax. However, the ECJ noted that the situations of a person liable to income tax and a person liable to wealth tax were similar in many ways.\textsuperscript{227} Following a brief examination, the Court came to the conclusion that the situations of residents and non-residents with regards to wealth tax were much the same as for income tax; i.e. not as a rule comparable.\textsuperscript{228} The major part of a taxpayer's wealth is usually held in his state of residence, making that Member State best suited to take into account his overall ability to pay and to grant him the appropriate allowances.\textsuperscript{229}

Mr D. raised the argument that because Germany had abolished wealth tax, there was no state in which he could get his personal and family circumstances taken into account for the purpose of granting an allowance. The Netherlands should therefore be forced to grant him the allowance, to avoid treating Mr D. less favourably than Dutch residents.\textsuperscript{230} This argument was rejected by the Court, which stated that the fact that his state of residence had abolished wealth tax had no bearing on the factual situation, and that he was still not in a situation comparable to residents of the Netherlands.\textsuperscript{231}

On those grounds, the ECJ ruled that the answer to the first question was that Articles 56 EC and 58 EC did not preclude legislation such as the one in question, where a Member State granted a tax allowance to its residents, but not to non-residents who held the major part of their wealth in their state of residence.\textsuperscript{232}

Thus, since the first question did not provide a solution to the D case, the door was opened for the ECJ to analyse the MFN problem.\textsuperscript{233}

\textbf{3.4.2.3 Compatibility of Articles 56 EC and 58 EC with not extending rules found in a bilateral tax treaty to residents of a Member State which is not party to the treaty}

Before answering the second question, the ECJ made some preliminary remarks on the Belgium-Netherlands tax treaty. The application of the treaty meant that a fictional Belgian resident who, just like Mr D., held 10% of his wealth in the Netherlands in the form of

\textsuperscript{226} Ibid, para. 30.
\textsuperscript{227} Ibid, para. 31.
\textsuperscript{228} Ibid, para. 38.
\textsuperscript{229} Ibid, para. 37.
\textsuperscript{230} Ibid, para. 39.
\textsuperscript{231} Ibid, paras. 40-41.
\textsuperscript{232} Ibid, para. 43.
property, would in the Netherlands be entitled to the tax allowances that was denied Mr D.\textsuperscript{234}

Some observations were submitted to the Court. Mr D. held that the difference between himself and a Belgian resident in an equivalent situation constituted discrimination, prohibited by the EC Treaty.\textsuperscript{235} Several governments, as well as the Commission, warned against extending benefits granted by tax treaties to Community residents not from any of the contracting Member States. Reference was made to the danger such a ruling would entail for existing bilateral treaties, as well as those who could be concluded in the future, and to the legal uncertainty that would follow.\textsuperscript{236}

The Court then briefly went over what had been established in earlier case law: In the absence of the adoption of any unifying or harmonising measures for the elimination of double taxation, the Member States are at liberty to, within the framework of bilateral tax treaties, determine the connecting factors for the allocation of the powers of taxation. The difference in treatment resulting from this allocation cannot constitute discrimination prohibited by the EC Treaty.\textsuperscript{237}

However, the issue at hand did not concern the consequences of allocation as it related to residents or nationals of Member States that were party to a tax treaty. Instead it concerned a comparison between a resident of a Member State that was party to a tax treaty and a resident of a Member State not party to that same treaty.\textsuperscript{238} The Court emphasised that the scope of bilateral tax treaties are limited to the natural or legal persons referred to in them.\textsuperscript{239} There were, however, situations in which benefits granted by a tax treaty could be extended to residents of Member States not party to the treaty.\textsuperscript{240} The ECJ referred to the judgement in \textit{Saint-Gobain} regarding permanent establishment of non-resident companies.\textsuperscript{241}

Unlike previous case law, where the situation of non-residents had been compared to the situation of residents, attempts where here made to compare the situation of one non-resident with another non-resident.\textsuperscript{242} Discrimination, by definition, can only arise when there is a difference in treatment between two persons in the same (or at least sufficiently similar) situation or the same treatment being applied to different situations.\textsuperscript{243} The ECJ held that the situation of Mr D. and the situation of a Belgian resident were not the same with regard to wealth taxation the Netherlands. This was justified by the argument that an inherent consequence of the Belgian-Dutch tax treaty was that reciprocal rights and obliga-

\begin{itemize}
\item \textsuperscript{234} Case C-376/03 \textit{D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen} [2005] ECR I-5821, para. 45.
\item \textsuperscript{235} \textit{Ibid}, para. 47.
\item \textsuperscript{236} \textit{Ibid}, para. 48.
\item \textsuperscript{237} \textit{Ibid}, paras. 50-52.
\item \textsuperscript{238} \textit{Ibid}, para. 53.
\item \textsuperscript{239} \textit{Ibid}, para. 54.
\item \textsuperscript{240} \textit{Ibid}, para. 55.
\item \textsuperscript{241} \textit{Ibid}, paras. 56-57.
\item \textsuperscript{242} \textit{Ibid}, para. 58.
\item \textsuperscript{243} Case C-279/93 \textit{Finanzamt Köln-Altstadt v Rolander Schumacker} [1995] ECR I-225, para. 30.
\end{itemize}
tions applied only to residents of those two states.\textsuperscript{244} The rule in question was to be regarded as an “integral part” of the treaty and “contribut[ing] to its overall balance” and could therefore not be regarded as a benefit separate from the rest of the tax treaty.\textsuperscript{245}

Since the two situations were not held to be comparable, the answer given by the ECJ to the second question was that Articles 56 EC and 58 EC did not preclude a tax treaty rule such as the one question from not being extended, in situations and circumstances such as those at hand, to residents of a Member State not party to the treaty.\textsuperscript{246}

3.4.2.4 Comments

While the first question is interesting in its own right, it is the second question that has an impact on the area of tax treaties and the MFN-principle, which is why the commentary on that part of the ruling will be more detailed and in-depth.

Still, it could prove informative to at least compare the final ruling on the first question with the Advocate General’s Opinion\textsuperscript{247}, especially since the ECJ did not follow that recommendation. Just as the ECJ, the AG acknowledged the fact that the situations of residents and non-residents are not as rule comparable with regard to income tax, and transferred this to the area of wealth tax as well. As is evident from the ruling of the ECJ detailed above, the Court stopped at this point and held the two situations as not being comparable. However, the AG held that the two situations were indeed comparable in this case. He based this on the argument that the threshold of 90\% (the percentage of a non-residents income or wealth that has to be held in the other Member State for the non-resident to be considered in the same situation as a resident of that state) should be applied to the taxable income or wealth. Since Germany had abolished wealth tax, 100\% of Mr D:s taxable wealth was held in the Netherlands in the form of property. Therefore, the AG found, in contrast with the ECJ, that Mr D, as a non-resident, was in a comparable situation to a resident and should be allowed the tax-free allowance.\textsuperscript{248}

Moving to the second question, the core of the case as regards tax treaties and the MFN-principle, it would seem appropriate to begin with the opinion of the AG. The AG held that the situations of Mr D and a Belgian resident were comparable with regard to wealth tax in the Netherlands and that Mr D should be granted the allowance. Of great interest are some of the statements of the AG with regard to the effects applying the MFN principle would have on the tax treaty system. The dangers this would bring about for the equilibrium and reciprocity of that system was noted, but the establishment of the single market and the fundamental freedoms were ultimately held to take precedence over such perils.\textsuperscript{249} This stance of the AG is reflected in this quote from the Opinion:

\begin{quote}
This stance of the AG is reflected in this quote from the Opinion:
\end{quote}

\begin{footnotes}
\item[244] \textit{Ibid}, para. 61.
\item[245] \textit{Ibid}, para. 62.
\item[246] \textit{Ibid}, para. 63.
\item[247] C-376/03 Opinion of Mr Advocate General Ruiz-Jarabo Colomer delivered on 26 October 2004. \textit{D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen.}
\item[248] \textit{Ibid}, paras. 68-71.
\item[249] \textit{Ibid}, para. 101.
\end{footnotes}
An affirmative reply to the [MFN question] would severely fetter the complex system of bilateral agreements for the avoidance of double taxation in the Community, but it would not be the first time that a ruling of the Court of Justice caused upheaval in the legal systems of the Member States."  

However, as with the first question, the ECJ chose not to follow the recommendation of the AG. As will be seen below, the outcome of the D case was highly controversial and has been hotly debated in the literature. Some legal scholars appear to agree with the Court concerning the result of the ruling, but even among them it seems that a majority feel that the way in which the ECJ arrived at this ruling contains some heavily flawed arguments and was not done in a way consistent with previous case law.

One heavily criticized aspect of the ruling has been what appears to be the circular reasoning of the Court when it determined that the situations of non-residents and residents in a Member State party to a tax treaty were not comparable. The original difference in treatment (and alleged discrimination) had arisen because the tax treaty only applied to residents of the Member States that were party to the treaty. However, the Court deemed the situations not comparable because of the fact that the treaty only applied to residents and nationals of the Member States that were party to it. In essence, the cause of the difference in treatment was also held to be the reason as to why the situations were not comparable, and therefore there was no discrimination.

It has been pointed out that this approach of the ECJ, citing that the reciprocal rights and obligations applying only to residents of one of the two contracting Member States is an inherent consequence of bilateral tax treaties, is in conflict with previous case law. In fact, quite the opposite has been held in previous cases: the EC Treaty does not allow for equal treatment to be made dependant on conditions of reciprocity.

Another matter is the refusal of the Court to separate the relevant provision from the rest of the treaty, claiming that it is an integral part thereof. Because of this, questions have been raised if any parts of a tax treaty could be held as separable from the rest of the treaty, when such a tiny part as the provision at hand in the D case can be held as "integral". Certainly, more central provisions, such as provisions on withholding tax rates and thresholds for PEs, could not be held as separable.

There are those that feel that the Court’s ruling in the D case was a premature overreaction to the MFN problem, and that the fears of far-reaching consequences were unfounded. Instead, application of the MFN concept to tax treaties within the EU would be subject to a number of limitations.

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250 Ibid, para. 105.
jurisdiction and avoid double taxation, which according to the ECJ cannot give rise to discrimination.\textsuperscript{255}

The ruling of the Court in the \textit{D} case could have serious consequences for the concept of the internal market. It has been argued that the outcome of the case gives the Member States free reign to keep questionable tax provisions outside the scope of Community rules on free movement and non-discrimination, simply by including them in bilateral tax treaties, where they would be “untouchable”.\textsuperscript{256}

3.5 Economic and political aspects

3.5.1 Introduction

In this part of the chapter the work of the ECJ will be examined with to try to present some of the political and economic aspects that the Court have and will take into consideration when faced with certain problems relating to the harmonization and integration of EC law and national law of the Member States. It should already be noted that when dealing with these sorts of factors it will be hard to distinguish between political and economic thinking and that distinction does not serve any real purpose in this thesis and will therefore not be expressly stated.

This part of the chapter will begin with a presentation of some the special circumstances that make the ECJ such an important institution and will also try to explain some of the rather unorthodox ways in which the ECJ have used the discretion it has when it comes to its judgments. This will be followed by a look at the situation as it is now and some predictions for the future regarding tax law and the ECJ.

3.5.2 The ECJ and the EC

The ECJ is one of the institutions of the European Communities.\textsuperscript{257} It is tasked with making sure that the primary and secondary legislation of the EC is adhered to. This task includes upholding the direct rules found in the treaty, such as the rules on the ban of discrimination, the rules in secondary legislation, such as the Parent-Subsidiary directive\textsuperscript{258}, but also to protect the principles and rules that are not expressly evident from the wording of any legislation, such as the principle of state liability that stems from the rules on loyalty between the Member States and the EC.\textsuperscript{259} The most central part of what is done in the ECJ is the interpretation of the different sources of law; this is mostly done through the process

\begin{itemize}
  \item \textsuperscript{255} van Thiel, S., Why the ECJ Should Interpret Directly Applicable European Law as a Right to Intra-Community Most-Favoured-Nation Treatment, European taxation, Issue 7 2007, Amsterdam, p. 316.
  \item \textsuperscript{256} Schuch, J., Critical notes on the European Court of Justice's decision on most-favoured-nation treatment under tax treaties, p. 8.
  \item \textsuperscript{257} Article 220 EC.
  \item \textsuperscript{258} Council directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.
  \item \textsuperscript{259} Article 10 EC.
\end{itemize}
of giving preliminary rulings to national courts.\textsuperscript{260} Cases can also be brought before the Court by the Commission.\textsuperscript{261}

There are a number of reasons why the ECJ is such a special court. These reasons will not be discussed at length here since elaborations on these subjects would become too lengthy. The first reason that comes to mind as an explanation to why the Court is rather special is because it is a necessity because of the situation it is in. The ECJ is an institution of one of the largest unions of sovereign states ever to be created. In its judgments it has to take into consideration not only the EC law and the national law in certain areas. It will also take heed of the current political will of the Member States if possible and also it will try in any given situation to ascertain what is the best course of action for the inner market and the Union as a whole. Because of the fact that the ECJ is a court in a rather uncommon situation, it will sometimes make atypical interpretations of the problem before it and the solutions needed.

Another thing that puts the ECJ in a situation that is dissimilar to many other courts is the source of law available to the Court. There are both primary and secondary EC legislation,\textsuperscript{262} but this discussion will mostly be about the EC Treaty. The treaty was drafted as, and still is, mainly a political instrument.\textsuperscript{263} This means that the Court in many cases will have to look through the text of the treaty to find the meaning behind it. The Court will almost always in these cases try to ascertain what the reasons where for creating the provisions at hand and find out what the rules were meant to achieve. This means that the Court over the years have had to “create” rules of law from a document that was not written as law. This situation has meant that the ECJ has in its case law taken some really significant decisions, not only judicial but also political.\textsuperscript{264} Some of the important principles of EC law have been “created” by the ECJ, for example the principle of state liability.\textsuperscript{265}

The ECJ will take into consideration the political implications of its judgments most of the time it seems. Many judgments of the Court will have a reasoning that is influenced by political arguments. This is partly because of the situation it is in and the sources of law at its disposal, but also because of the aims of the Court. There are a number of clearly stated goals the work of the Court, for example the interpretation of the EC law and the review of legality of acts passed by institutions of the EC. There are also goals that are not so easily read from the treaty, such as the protection of the inner market. The protection of the inner market is one of those goals that has lead the Court to make some decisions based on political or economic aspect as well as purely community law ones, the protection of the inner market is in itself an economic goal more than a legal one. The case law of the ECJ on direct taxation gives a number of examples where the economic implications of judgments have been taken into consideration. It can even be said that the Court “brought” direct taxation within its sphere of competence because of the impact rules on income and

\textsuperscript{260} Article 234 EC.
\textsuperscript{261} Article 226 EC.
\textsuperscript{262} Primary legislation being treaties of the EC and secondary regulations and directive and similar sources.
\textsuperscript{263} Wiklund, O, EG-domstolens tolkningsutrymme, Juristförlaget, Stockholm, 1997, p. 91.
\textsuperscript{264} Ibid, p. 88.
\textsuperscript{265} The principle of state liability means that Member States can under certain conditions become liable to pay for damages suffered because of that states breach of EC law. This is mainly directed at the implementation of directives, but it can also be other actions by the states.
corporate taxation can have on the inner market. It has since then been debated if it was right of the Court to do so, and also the Court has taken the political will of the Member States into consideration many times in this field since taxation is one of the most important issues for any nation state.

3.5.3 The current situation

It is not probable that the ECJ will change its case law on direct taxation or tax treaties in the near future. There has recently been an enlargement of the Union and judges from the new Member States are probably less inclined to be positive towards harmonization of taxation legislation. There is also at the moment an opinion amongst the Member States that if there is to be more harmonization of taxation in the EC, it should be done through the political process of the EC. Within the EC there are some projects at the moment in the field of direct taxation. The Commission will during 2008 present a paper on a common consolidated tax base that would, if it can be accepted, change the corporate taxation in the EC significantly. The Commission also continues its work in the field of tax treaties and, it seems at the moment that the Commission and academics are mostly interested in creating common rules in the filed of double taxation. Since the Court has show a reluctance to continue its work of reviewing tax treaties from the point of EC law at the moment, it is probable that some political initiative is needed if the integration and harmonization of taxation rules in the EC is to continue.

3.6 Summary

Even though the ECJ have stated that rules on allocation of taxation rights are not capable of being discriminatory on the basis of nationality, there are a number of provisions in tax treaties that run the risk of being incompatible with EC law. It is not the actual rules that are put into place to alleviate or abolish double taxation that will be the larger problems, but rules relating to other questions in the treaties such as exclusion from benefits or rules relating to abuse of the treaties. A few treaty rules have been challenged before the Court and there is now a greater understanding of what sort of rules will run the risk of breaching EC law. Even though there has been some case law on the subject, there are still a number of unanswered questions about tax treaties, and a number of provisions of tax treaties in place now would possibly be found to be in breach of EC law if they were to be put before the Court. Some of these provisions are limitations of benefits, trailing taxes and the most favoured nation treatment.

The MFN principle and the question of if EC law prescribes its application on tax treaties concluded between Member States is a much debated subject. Both the “Believers” and the “Unbelievers” had hoped that the ruling of the Court in the D case would bring some clarity to the matter. However, while the outcome of the case seems to signal a resounding “no” to the aforementioned question, the way in which the Court arrived at its answer has been heavily criticized.

The Court dodged the issue of MFN treatment in tax treaties by declaring the situations of two non-residents not comparable, when one of them is from a Member State which is party to the relevant tax treaty. Because the situations were not held to be comparable, no discrimination could arise. This circular reasoning was justified by, *inter alia*, reasons of reciprocity, which is in direct conflict with earlier established case law.
The ruling of the ECJ stands in contrast to the opinion of the AG. AG Colomer noted the dangers that applying the MFN principle would bring about for the tax treaty system, but gave precedence to the establishment of the single market and the fundamental freedoms.

There are also those that are of the opinion that the Court overreacted in the D case and that applying the MFN principle in that specific case would not have had such far-reaching consequences as was thought.

In fact, it is the Court’s decision that may have unwanted consequences, giving Member States too much freedom in putting “questionable” provisions in tax treaties.

Taking the above mentioned reasons into mind, it is our opinion that it is unclear how much weight should be attributed to the ruling in the D case. Thus, the question of the MFN principle and what EC law says about its application to tax treaties concluded between Member States is still open, and it would be advisable to seek out a better suited solution to this problem.

The judgment in the D case is an example of the Court taking political and economic concerns into consideration when in its work. The outcome of that case is based largely on the notion that the Member States were against such a principle and that the economic implications would be far reaching. Also it might be possible that the Court actually reasoned that it might be detrimental to the will of Member States to conclude double taxation treaties if the Court would find that they had to give way to the most favoured nation treatment.
4  Solutions

4.1  Introduction

This chapter will deal with the proposed solutions to the problems described in the previous chapter, i.e. the problems created by the conflict between tax treaties and Community law.

The Courts attempts to solve the situation by interpreting Community law has so far not led to a satisfactory result. Most agree that the way forward is through positive integration.\(^\text{266}\)

There are a number of proposed solutions, but two alternatives will be investigated in greater detail: a Multilateral EU Tax Treaty and an EU Model Tax Treaty. These ideas are not new and attempts have been made in the past to realize them, without much success. However, for the moment, these two methods have surfaced as the most interesting options for the future multilateralization of the tax treaty network within the EU.

4.2  Alternative solutions

4.2.1  Introduction

Even though the Multilateral EU Tax Treaty and the EU Model Tax Treaty are the main approaches and the focus for this chapter, there are a number of other options that have been proposed in order to resolve the conflict between tax treaties and Community law.

Besides the Multilateral EU Tax Treaty and the EU Model Tax Treaty, four solutions have been identified by Pistone as having been proposed by tax scholars. These solutions are: the “judicial application of the MFN doctrine”, the “purely international solution”, the “purely Community law solution”, and “strengthening source taxation”.\(^\text{267}\) These alternative solutions will here be dealt with briefly, before moving on to the two main methods.

4.2.2  Judicial application of the MFN doctrine

*Prima facie*, the judicial application of the MFN doctrine could be seen as the easiest and fastest instrument by which to ensure that equal access to the internal market is ensured. None of the existing bilateral treaties between Member States would need to be renegotiated, nor would a political solution be required.\(^\text{268}\) Nationals of any Member State would have access to any advantages granted by a tax treaty concluded by the Member State in which they operate, regardless of which state those advantages were originally intended for. Thus, no discrimination would occur and compatibility with Community law would be ensured.


\(^{267}\) Ibid, p. 207.

However, the possible ramifications of letting the MFN principle “run rampant” within the Community are far-reaching. The effect such an approach would have on the coherence of the tax treaty network within the EU and the Member States’ respective domestic tax laws have been more thoroughly above and will not be further explored here. Suffice to say that many scholars believe that the negative effects that would follow the judicial approach of the MFN doctrine overshadow any positive effects it would have as regards preventing discrimination. The ECJ seems to share this sentiment, and has in its case law been adamant against accepting the application of the MFN doctrine on tax treaties as part of Community law.269

With this taken into account, the judicial application of the MFN doctrine does not seem to be an adequate solution to the problems encountered in the conflict between Community law and tax treaties. In fact, should this method be used, the incoherencies resulting from its use would most likely force the Member States into concluding a multilateral tax treaty in order to remove them, which further points to the need to solve the issue by way of positive integration.270

4.2.3 The purely international solution

Proponents of the alternative known as the “purely international solution” argue that the competence granted to Member States by way of Article 293 EC places the responsibility to remove the conflict on the Member States themselves, by way of concluding tax treaties. However, the evolution of Community law in the field of direct taxes and tax treaties may signify a mitigation of this conclusion.271 The case law of the ECJ has made clear that the Member State must pay regard to Community law when exercising their power to draft treaties and that the Court is competent to test such actions for compliance. Consequently, the Member States can no longer simply include the OECD Model provisions in their tax treaties, but must alter such provisions so that they do not conflict with Community law. Such revisions of the existing bilateral tax treaties would require tax co-ordination between the states, which in turn leads to the conclusion that one can no longer refer to a purely international solution to the conflict between EC law and tax treaties.272

4.2.4 The purely Community law solution

The “purely Community law solution” is based on the removal of the conflict through secondary Community law, i.e. through directives.273 The main argument against this solution appears to be that it represents an approach that is too advanced as Community law stand today.274 For instance, it follows from the principle of subsidiarity that Community legislative measures shall only be issued when the result to be achieved cannot be reached through domestic legislation. In addition, a directive in this field could mean that existing bilateral tax would be deprived of their function. Lastly, attempts to harmonize direct taxa-

269 See section 3.4.2.

270 Pistone, P, The Impact of Community Law on Tax Treaties, p. 213.


tion, at an even lower level than what this solution would signify, have so far been opposed by many Member States in the Council. It therefore follows that the purely Community law solution is not yet a realistic option, at least not at this point in time.

### 4.2.5 Strengthening source taxation

The final alternative solution concerns strengthening the taxing powers of the source-states. A return to a stronger sourced-based taxation could grant equal treatment to taxpayers according to their substantial situation and their residence would be of little consequence.

A few different views on in what way source taxation should be strengthened have been presented. Among them are higher withholding taxes in the source state, granting full taxing powers to the source state, and the introduction of an optional regime of fractional taxation based on pure territoriality.

Since a shift to a source-based taxation system would in effect be a great upheaval for the systems for income taxation within the Community, a number of controversial issues are raised by these variations. However, the discussion of these issues falls outside the scope of this thesis.

### 4.3 A Multilateral EU Tax Treaty

#### 4.3.1 About the Multilateral EU Tax Treaty

One of the approaches that have been advocated as a solution to the problems caused by the conflict between tax treaties and Community law is the adoption of a Multilateral EU Tax Treaty. This treaty would be based on the OECD Model, with the relevant changes made. It would be signed by all Member States and replace all existing tax treaties between those states.

Among the important changes that would have to be made would be to adjust the OECD Model provisions to cover not only residents of two contracting states but also residents of more than two contracting states, thereby making them suitable for a multilateral treaty. For example, the rules on allocation and method provisions must be able to distinguish not only between a state of residence and “the other” contracting state, but also between the state of residence and several other contracting states. With regards to the method provisions, there is no need to make an absolute choice between the credit method and the ex-

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276 Pistone, P, The Impact of Community Law on Tax Treaties, p. 201.


278 Pistone, P, The Impact of Community Law on Tax Treaties, p. 221.


280 Ibid, p. 132.

emption method. It would be possible to apply one method to residents of some contracting states and the other method to residents of other contracting states, or to apply one method to specific kinds of income and the other method to other kinds of income. What is important is that no distinction is made between situations depending on which other contracting state the income originates from.\textsuperscript{282}

Since the ECJ is a court common to all Member States, which has ruled on tax cases many times, it would be an obvious choice to design a provision which allocates the competence for the interpretation of a Multilateral EU Tax Treaty to the Court.\textsuperscript{283}

Apart from changes of the just mentioned nature, some changes to the substance of the provisions have to be made in order for the treaty to better correspond to Community law, e.g. changes related to non-discrimination. While giving any further examples would fall outside the scope of this thesis, we refer to the Multilateral EU Tax Treaty draft proposed by the Department of Austrian and International Tax Law at the University of Economics and Business Administration in Vienna for examples of how provisions in such a treaty could be designed and how they would differ from their counterparts in the OECD Model.\textsuperscript{284}

If attempts to conclude a fully multilateral tax treaty would prove unsuccessful, there are suggestions to try and implement a “partial” multilateral tax treaty instead. This partial treaty would consist of the generally accepted provisions from the OECD Model Treaty and would take precedence over the existing bilateral tax treaty network in those areas. However, that tax treaty network would remain in force and areas which are disputed would remain in the realm of such treaties; with the hope that the partial multilateral tax treaty would be improved and broadened in scope until it one day encompassed those areas as well.\textsuperscript{285}

4.3.2 Arguments in favour of a Multilateral EU Tax Treaty

One important argument in favour of concluding multilateral tax treaties is that they reduce competitive distortions. When a business decision has to be made on where to make an international capital investment, even the smallest factor could tip the scales in favour of one state or the other. While questions of taxation are not usually at the forefront in such matters, they may nevertheless be of great importance in the decision-making process. In such situations, states which have concluded tax treaties containing favourable provisions are at an advantage compared to states which have not.\textsuperscript{286}

For example, Member State A has concluded bilateral tax treaties with both Member State B and Member State C. Applying the A-B treaty on a capital investment would result in a final tax burden that would be slightly lower than if one applied the A-C treaty on a similar investment. All other things being equal, it is likely that company looking to make a capital investment will do so in Member State C rather than in Member State B. Member State B

\textsuperscript{282} Ibid, p. 194.

\textsuperscript{283} Ibid, p. 194-195.

\textsuperscript{284} Ibid, p. 197-245.

\textsuperscript{285} Ibid, p. 103.

\textsuperscript{286} Ibid, p. 88-89.
therefore suffers a competitive disadvantage as concerns placement of capital investments by companies from Member State A, when compared to Member State C. In order to be placed on equal footing with Member State C, Member State B must revise its tax treaty with Member State A.\textsuperscript{287}

Such competitive distortions are a consequence of the bilateral tax treaty system, and could be avoided by instead concluding one multilateral tax treaty. The multilateral treaty would be helpful in trying to ensure that the treaty effects on the international flow of capital remained the same throughout all the contracting Member States.\textsuperscript{288}

One aspect of international double taxation which dealt with to any higher degree by the present tax treaty network is the problem relating to taxation that emerges in triangular cases. Not even in cases when there exist bilateral tax treaties between all three of the involved states is the protection against such overlapping taxation sufficiently developed. A multilateral treaty would be in a better position to take regard of such triangular situations, and to develop a solution.\textsuperscript{289}

Taking a practical perspective, one multilateral tax treaty that covers all EU Member States would be far less complicated to get an overview of than the combined number of the vast amount of bilateral tax treaties present between the states today.\textsuperscript{290} This would in turn help to improve legal certainty. Today, every bilateral treaty is considered a separate source of law that has to be applied and interpreted on its own merits. The fact that many treaties are based on the OECD Model Tax Treaty is a mitigating factor, since the OECD has recommended the Member States to use the OECD Commentary when interpreting provisions based on the Model. However, there are many issues not dealt with in the Commentary. A provision in a bilateral treaty may not necessarily be interpreted in the same way as a comparable provision in another treaty. Legal uncertainty arises and it is in some cases difficult to predict how a tax treaty provision should be interpreted. One single multilateral tax treaty would alleviate this problem, since interpreting the same source of law in two or more different ways would be unacceptable.\textsuperscript{291}

Another facet of a multilateral tax treaty that would help improve legal certainty is that there would be a need for closer co-operation between the tax administrations of the Member States, since an issue relating to the interpretation of the multilateral treaty would be relevant in all contracting Member States.\textsuperscript{292}

Finally, another compelling argument is the immediate application of revised provisions of a multilateral treaty. Past experience has shown that there is a growing need for revisions of OECD Model provisions to be made on a continuous basis.\textsuperscript{293} This is a necessary aspect of

\textsuperscript{287} Ibid, p. 89.
\textsuperscript{288} Ibid, p. 89.
\textsuperscript{289} Ibid, p. 91-92.
\textsuperscript{290} Kofler, G.W, Most-Favored-Nation treatment in direct taxation: Does EC law provide for Community MFN in bilateral double taxation treaties?, Houston Business and Tax Law Journal, Volume 5 2005, p. 88.
\textsuperscript{291} Lang, M, et. al. (eds.), Multilateral Tax Treaties – New Developments in International Tax Law, Kluwer law, p. 90.
\textsuperscript{292} Ibid, p. 91.
\textsuperscript{293} Ibid, p. 92.
the OECD Model, but one that nevertheless may have negative implications for the tax treaty network. With international tax treaty law becoming increasingly complicated and the amount of tax treaties increasing, it is inevitable that the Member States will “lag behind” in updating and amending their bilateral treaties to correspond with the changes in the OECD Model. In addition, there is the possibility that courts will misunderstand an attempt to clarify a Model provision as a change in the substance of the provision, which could work to the detriment of the not-yet-updated provision provided for by the relevant bilateral treaty. In these respects, a multilateral tax treaty would, at least in theory, be easier to maintain, as not only would there only be a need to keep one legal document updated, but any changes made to it would immediately be applicable in all contracting Member States.  

4.3.3 Arguments against a Multilateral EU Tax Treaty

Numerous attempts have been made in the past to conclude multilateral tax treaties within different regions and organizations. The majority of these attempts have failed. Examples of failed attempts to conclude multilateral tax treaties are those made by the League of Nations in 1931, the European Economic Community (EEC) in 1968 and the European Free Trade Association (EFTA) in 1969. These failures are often used as arguments against the idea of a multilateral tax treaty. The inability of the EEC to produce a multilateral tax treaty does not bode well for the Multilateral EU Tax Treaty, as opponents of the idea wonder why the result would be any different now than it was decades ago. There have been some successful attempts though. In fact, it could be argued that the multilateral double taxation treaty between Denmark, Finland, Iceland, Norway and Sweden (the Nordic Treaty) would be a good example of a multilateral tax treaty functioning very satisfactorily. However, as the Nordic states have a history of close cooperation and share similar legislation in the field of taxation, the Nordic Treaty is not such a suitable comparison for a Multilateral EU Tax Treaty as one might think, especially not considering such a treaty would be concluded between 27 (at present) Member States, all with wildly different history, culture and legal climates.

It is a fact that tax systems and economic realities vary considerably from state to state. This only becomes more apparent when there is an attempt made to compare several states within one large region, such as the EU. It is felt by many that it is easier to take such divergences into account on a bilateral basis, rather than under a multilateral approach.

Another factor that could prove to be an obstacle in the way towards the development of a multilateral tax treaty is the substantial work input needed to produce such a treaty. The sheer amount of resources that would have to be allocated to such a project in order for it

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294 Ibid, p. 94.
295 Ibid, p. 86.
296 Ibid, p. 94.
299 Lang, M, et. al. (eds.), Multilateral Tax Treaties – New Developments in International Tax Law, p. 95.
to succeed, could prevent tax authorities, already under heavy budgetary constraints, from becoming very enthusiastic about the idea.\textsuperscript{300} Lastly, one of the more convincing arguments against a Multilateral EU Tax Treaty appears when it is compared to the alternative of an EU Model Tax Treaty, namely that such a measure could be seen as disproportionate as to the purpose to be achieved.\textsuperscript{301} It would thus be in breach of the EC principle of proportionality. For the multilateral tax treaty solution to be effective, the already existing double taxation treaties between Member States would need to be removed and replaced by the Multilateral EU Tax Treaty. Arguments can be raised that the less drastic approach of an EU Model Treaty would be sufficient to ensure compatibility with Community law.\textsuperscript{302}

4.3.4 Comments

The concluding of a Multilateral EU Tax treaty is one of the more prominent suggestions on how to solve the problems brought about by the conflict between tax treaty law and EC law. The ability to reduce competitive distortions and better take regard of triangular cases would be of great help to ensure equal treatment on the inner market. The practical perspective is also of great significance, with the strengthened legal certainty that would follow a single treaty, which would be both easier to overview and to update than the mass of treaties existing today and also have provisions that would be immediately applicable in all contracting states after a revision is made.

Even so, while the concept of a Multilateral EU Tax Treaty sounds quite interesting in theory, there are doubts about how well it would work in practice. It is the authors’ opinion that the solution does not stand a realistic chance of being implemented at this point in time. The vast differences that exist today between the different Member States’ tax systems makes agreeing on uniform provisions that would cover all of the contracting states seem like an impossible goal. There is an overwhelming risk that, in order to reach a compromise that could be agreed on by everyone, the final result would be insufficient to reach its aims and thereby lose all meaning, despite the amount of work that would be needed in order to conclude such a treaty. Also, the fact that similar attempts have failed in the past is not encouraging.

However, it is worth mentioning that, if the trends of harmonization continue, there is every chance that the current obstacles against a Multilateral EU Tax Treaty could be lessened and the solution would become a more realistic option.

Some of the above mentioned concerns could be alleviated by going the route of a “partial” multilateral treaty. However, there is still the problem of proportionality. If a “less intervening” solution such as an EU Model Treaty would be a sufficient solution, the Multilateral EU Tax treaty would, by extension, be disproportionate as to the aims to be achieved and thereby not the most suitable solution to the relevant problems.

\textsuperscript{300} Ibid, p. 95.

\textsuperscript{301} Pistone, P, An EU Model Tax Convention, p. 132.

\textsuperscript{302} See section 4.4.2.
4.4 An EU Model Tax Treaty

4.4.1 About the EU Model Tax Treaty

A possible option to concluding a multilateral tax treaty within the EU is the introduction of an EU Model Tax Treaty. Such a model would include rules that give guidance to how Member States can conclude tax treaties without the risk of being in breach of EC law.

The Commission has expressed the view that the Member States tax treaties should be improved in order to better comply with the principles of the internal market and that better co-ordination is needed when it comes to the relationships with third states. It also stated that it was the Commissions opinion that the most promising way of achieving these goals would be to agree on an EU version of the OECD Model Tax Treaty and its Commentary.

The Commission has later reiterated its view on the problems related to double-taxation and noted that the current lack of co-operation in the area will lead to an increasing number of problems. The Commission believes that:

"Without community action, there may be important political and economic repercussions for the Member States' policies in this area."

There is sufficient documentation to state that the Commission believes that there is a growing problem with double taxation treaties within the European Union. From the communications by the Commission it can be concluded that the most favoured solution to the problem at this time is an EU Model Tax Treaty. The following will be a presentation of how such a Model treaty could be drafted and how it would function.

To reach an agreement on a draft for an EU Model Tax Treaty can be problematic. It is not clear what form the Model should have. There are questions related to both the drafting and the signing of any treaty. There have been a number of suggestions of how an EU Model Tax Treaty should be decided and published. A workshop of experts published a working document on tax treaties and community law in 2005. The paper suggests that the standard provisions of an EU Model Tax Treaty should be issued by the Commission in the form of a recommendation. It is also suggested that the Member States should be allowed to make reservations and add comments in the hopes of gaining approval for the EU Model. Any such reservations could jeopardise the very function of the Model according to Pistone, who argues for another solution on how to regulate the EU Model Tax Treaty. The solution presented by Pistone is rather different and also interesting in another way since it includes an example of how the EU Model could be formulated. He en-

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305 Com(2003) 726, An Internal Market without company tax obstacles achievements, ongoing initiatives and remaining challenges, p. 11.
306 Ibid, p. 11.
308 Ibid p. 17.
309 Ibid, p. 17.
visions a treaty being negotiated according to Article 293 EC. Such a treaty would then be signed by all the Member States, making it a sort of hybrid between an instrument of international law and EC law. In our view, the most important issues when deciding the legal form of an EU Model Tax Treaty is that the terms used in tax treaties by the Member States are based on Community law, that the functioning of the EU Model Tax Treaty, and treaties based on it, falls under the jurisdiction of the ECJ and that the Member States are under an obligation to conclude their tax treaties with each other in accordance with the Model.

Another problem that has to be resolved before an EU Model Tax Treaty can be drafted is if it should cover all provisions necessary to a tax treaty or if it should only contain provisions necessary in order to comply with EC law. According to both Pistone and the workshop of experts the best solution is to only create provisions necessary to comply with EC law. Such a solution has at least two different strong reasons behind it. One is that a new Model would take more time and require more negotiations and compromise than would be necessary if only a limited Model is created. The other is that the systems of tax treaties would keep some of its flexibility, which is a good thing as long as it is not used in a way that is contrary to EC law. A related question could be if “provisions necessary in order to comply with EC law” would include only provisions based on the already settled case law of the ECJ regarding tax law rules contrary to EC law or also contain provisions based on findings of articles in the OECD Model that are possible of being in breach of EC law. However, it is clear that there should only be specific provisions based on EC law if absolutely necessary, since it will limit the problems faced when negotiating the Model between the Member States.

Another problem connected to this is if the Member States should be allowed to derogate from the Model at all. If they are allowed to do so it will take away a lot of the meaning of the Model since it will be put into place to make sure that all Member States have rules in their tax treaties that are not contrary to EC law. If on the other hand the Member States are not allowed to derogate from the rules, it can be questioned if it really is a Model Treaty, since the thought behind that instrument is to give guidance to possible solutions and to communicate opinions from different sources. The solution to this problem is connected to how the convention is formulated and written. If a “full” EU Model Tax Treaty is concluded it can contain some provisions that it would be allowed to derogate from and some that will be needed to be followed to the letter. In this way it will be a Model, but with some provisions that the Member States are forced to have in their tax treaties between themselves. In the other case where the treaty only contains provisions necessary to comply with EC law, all the rules are such that the Member States are forced to include them in their tax treaties. If this model is applied it is a Model Tax Treaty in the sense that Member States are allowed to go further in their tax treaties and all provisions not in the Model will be up to the Member States to decide, in so far as they are not contrary to EC law.

When it comes to the actual provisions to be found in the Model, there are at least three different kinds that have to be included. The first is provisions that give definitions to the

concepts that need to be interpreted in accordance with EC law; these include dividends and interests among other. The second is the substantive rules that have to be implemented in the treaty so as to make certain that the treaties between the Member States are not infringing EC law. These provisions will be based on the case law of the ECJ and on the directives that have been passed in the field of direct taxation.\textsuperscript{315} Provisions that have to be included are rules on dividends, the scope of the convention and the rules on abusive practices and the general rules regarding discrimination and restrictions, which are related to the community. The third is that there must be a way to solve conflicts over the proper application of the convention. In the draft for an EU Model Tax Treaty presented by Pistone that problem is solved through the use of an article for the solution of conflicts.\textsuperscript{316} The solution is firstly based on a mutual agreement procedure where the Member States involved are obliged to remove taxation not in accordance with the convention if a person who is affected by said taxation reports this to the competent authorities.\textsuperscript{317} If the problem can not, within one year of it being reported, be solved in this way, the competent authorities shall present the case before the ECJ, which may oblige them to carry out any adjustments to solve the problem.\textsuperscript{318}

4.4.2 Arguments in favour of an EU Model Tax Treaty

One of the most compelling arguments for an EU Model compared to a Multilateral EU Tax Treaty is there would be no need to tear up all the bilateral tax treaties already in effect between the various Member States. The Model would only consist of the changes that have to be made to comply with EC law and therefore the model would be less disruptive when it comes to the Member States tax treaties. In order to comply with the EU Model, some provisions of the treaties would have to altered, removed, or added, but those provisions not conflicting with Community law and dealing with strictly bilateral concerns could remain.\textsuperscript{319} This will mean that any provisions that do not need a Community revision will continue to be completely up to the Member States. This would leave the Member States free to decide on any matters of economic importance to them as long as they are not in breach of EC law. The EU Model approach to dealing with the problems of tax treaties within the Union would therefore be a more proportionate solution than a Multilateral EU Tax Treaty.\textsuperscript{320}

Another argument in favour of an EU Model Tax Treaty, albeit one that could also be used for the Multilateral EU Tax Treaty, is the gains in legal certainty it would lead to. The Model Treaty and the treaties based on it would include the same sort of language as treaties do now, but they would have to be interpreted in accordance with EC law and the Member States would be obligated to honour the meanings and interpretations given by

\textsuperscript{315} The Parent-Subsidiary directive, the directives on Mergers, Interest and Royalty, Savings Interest and the directive on Mutual assistance for the exchange of information.

\textsuperscript{316} Pistone, P, The Impact of Community Law on Tax Treaties, p. 365. The article is meant to replace article 25 of the OECD Model treaty, on mutual agreement procedures.

\textsuperscript{317} Pistone, P, The Impact of Community Law on Tax Treaties p. 366.

\textsuperscript{318} Ibid, p. 367.

\textsuperscript{319} Kofler, G.W, Most-Favored-Nation treatment in direct taxation: Does EC law provide for Community MFN in bilateral double taxation treaties?, p. 88.

\textsuperscript{320} Pistone, P, An EU Model Tax Convention, p. 132.
the ECJ and any other institution that will have the right to issue interpretations or meanings of a similar function. Even though this would not lead to all tax treaties between Member States having the same content, it would at least mean that words and expressions would have the same meaning in different treaties and that any interpretations on the Model or treaties based on the Model done by the ECJ would be applicable to the other treaties based on the Model as well. This would create some needed integration and harmonization on the internal market regarding taxation.

The first two arguments presented here leads to a third one; the work needed to negotiate and implement a Model Tax Treaty based on EC law would be far less extensive than the work needed to create a Multilateral EU Tax Treaty. This is based on at least two different reasons, one being that the Model itself would include fewer provisions, or at least less changed provisions, and that would reduce the work needed. Secondly, many of the issues are already identified and have been put before the ECJ which has given judgments on them in terms of their compatibility with EC law. This would also reduce the work needed to reach a solution as even though there is a lot of work to be done before these provisions can be approved, the Court has already given the outer boundaries that needs to be adhered to. Problems relating to the negotiation and drafting of multilateral treaties on taxation was one of the reasons why no multilateral treaty was drafted between the EFTA states in the 1960s.321

4.4.3 Arguments against an EU Model Tax Treaty

One objection to the EU Model solution is that it does little to solve the problems encountered in the conflict between tax treaty law and EC law if it, like the OECD Model, remains simply a recommendation. The EU Model would, when compared to the OECD Model, indeed be better adapted to Community law and thus more suitable for use when drawing up bilateral tax treaties between Member States, but for it to truly have an effect on the multilateralization issue there would have to be an obligation for Member States to follow it.322 It therefore needs to be binding on the Member States and they need to be under an obligation to follow the provisions in the Model.

Another argument against the Model is related to the creation of it, and that is the problem of finding a suitable legal form for it. This has also been discussed above, but deserves another mention since it could create a significant problem even before the work on the Model could begin.

4.4.4 Further thoughts

A discussion on an EU Model Tax Treaty raises a lot of questions, too many, in fact, for this thesis to address them all. Because of this, we will here present some questions regarding an EU Model Tax Treaty that we have not been able to address thoroughly.

In order for the EU Model to be able to keep up with new developments in Community law, it would be necessary for it to have a structure that would lend itself well to fairly frequent revisions.323 To this end, Pistone proposes that the Commission should set up a


322 Pistone, P, An EU Model Tax Convention, p. 133.

permanent technical committee. The committee would include representatives from the Member States and supervise the EU Model in order to be able to put forward necessary changes. The work of such a committee should include the day to day revisions of the Model that could be needed according to changes in case law or of the introduction of EC legislation, but it should also include preparatory work before any major revisions to the EU Model or any other initiatives of the EU in the field of double taxation.

Another question that must be raised when dealing with an EU Model is that of whether or not membership of the OECD could create any problems for the Member States of the EU. The members of the OECD have taken it upon themselves to adhere to the OECD Model and its Commentary, and if the EU Member States will in the future use other rules among themselves, this could possibly create friction with some of the other members of the OECD.

Another thought that is interesting but which cannot be elaborated greatly here is that of Community loyalty. If the EC creates secondary legislation in the field of double taxation and tax treaties, will this imply that the Member States will have to take this into consideration when concluding treaties with states not part of the EC. Will such legislation make it necessary for the Member States to consider the interest of the other Member States and the EC as a whole when concluding treaties? It is a tough question to answer as of now, but it is clearly possible that such a development can occur.

### 4.4.5 Comments

Creating an EU Model Treaty would provide solutions to many of the problems, present and future, in the field of tax treaties in the EC. The EU Model would bring stability to an area of law that needs it at the moment. The EU Model has the possibility of creating a situation where there is actual clarity over how the Member States can use their competence in taxation matters to create tax treaties that are compatible with EC law. It will give clear rules where needed, but also leave the Member States with a large amount of flexibility. The EU Model would also give Community definitions to words used in tax treaties and the interpretations of the ECJ would be applicable to all the treaties that are based on the EU Model. The flexibility that the EU Model would give is largely because it would not contain more provisions needed. Any issue that does not need a Community solution would be left up to the Member States to decide in their own bilateral treaties. This would also mean that many of the existing treaties could be retained with adjustments for the EU Model. In our view the fact that the EU Model is less invasive when it comes to the existing treaties means that it would be far less difficult to negotiate than the Multilateral EU Tax Treaty.

Even though it would probably be easier to negotiate an EU Model Tax Treaty, there would be difficulties with this as well. Deciding on the issues resolved by the ECJ would probably not be very hard- It would mostly be a codification of the rules that the Court already has stated shall be applicable between the Member States. However, it could be rather difficult to gain a consensus on the rules that the Court has not yet given rulings on. Even so, compared to the Multilateral EU Tax Treaty it would be much less difficult to negotiate, draft and maintain the EU Model Tax Treaty.

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Finding a suitable legal form for the EU Model can also be a problem, but there is substantial work being done in expert groups under the Commission. We are of the opinion that the question of the legal form of the EU Model will be solved long before many of the other issues surrounding the Model.

As a final note we are convinced that the EU Model Treaty is the best solution to the problems with tax treaties in the EC, at least for the moment. Even though creating a multilateral treaty in the whole of the EU might be a more suitable solution in the future, it is far from being possible today. The EU Model Treaty is not only a good solution; it is also quite possible that it can be created in the near future.

4.5 Procedural issues

One problem that both the Multilateral Tax Treaty and the EU Model Treaty share is that of the procedural issues surrounding direct taxation. The EC treaty states that any steps taken on approximation of laws on direct taxation within the EC shall be done by unanimous decisions of the Council.\(^{325}\) This has made it very hard to create any EC legislation in the field of direct taxation since it is very hard to reach a consensus in the area of tax with so many different wills present. It was hard even before the enlargement, and it will be even more difficult now after it. Direct taxation is an area where the Member States are very keen to protect their own interests, since taxation is a very important issue for any state. Even though it is understandable that the Member States are defensive when it comes to direct taxation, this rule of unanimous decisions has hindered the development of direct taxation at an EC level.

The requirement of unanimous decisions is in the way of necessary changes in the policies on double taxation in the EC. Since every Member State has the possibility to stop any process of harmonization by not agreeing to it, the will to engage in negotiations is clearly hampered. If there was a requirement for a majority, even a large one, instead of unanimity, the Member States would be forced to take part in the work of creating EC legislation wholeheartedly. This would mean that there was a large incentive for the Member States to take part in negotiations and that the harmonization could really happen. As it is now, the requirement of unanimous decisions is hindering the harmonization that is needed.

4.6 Summary

There are a fair number of proposed solutions to the problems brought about by the conflict between tax treaties and EC law. Among them are what in this thesis has been called “alternative solutions”: the judicial application of the MFN doctrine, the purely international solution, the purely Community law solution, and strengthening source taxation. However, all of these proposed methods have flaws and drawbacks that make them unsuitable as solutions. Instead, two more promising methods have been identified in this thesis, namely a Multilateral EU Tax Treaty and an EU Model Tax Treaty.

The Multilateral EU Tax Treaty would be signed by all EU Member States and replace the existing tax treaties that are currently in force between them. The provisions of such a treaty would be based on the OECD Model treaty, with the relevant changes made so that it is more in line with Community law as well as better suited for a multilateral treaty.

\(^{325}\) Article 94 EC.
There are quite a few arguments in favour of a Multilateral EU Tax Treaty: the reduction of competitive distortions, increased legal certainty on the inner market when all Member States will apply the same tax treaty on cross-border situations, provisions that are interpreted in an identical manner across the EU, one easily updated document instead of several hundreds of bilateral treaties, and the immediate application of any revisions that are made to the treaty provisions.

However, there are also strong arguments speaking against the adoption of a Multilateral EU Tax Treaty. Numerous attempts have been made in the past to create multilateral tax treaties. Some of these attempts can be argued to have been successful, but the vast majority of them failed, such as the attempt made by the EEC in 1968. The Nordic Treaty, which is sometime cited as a multilateral tax treaty functioning well, is in fact not a good example to bring up when trying to address the chances of concluding a treaty that would encompass all of the various Member States of the EU, as the Nordic Treaty only applies to small number of states in an arena with relatively homogenous tax laws.

In order to bring about a treaty such as the one question, a great deal of work would be required and there would be a need to reach a solution that could be agreed on by all the Member States. Even so, there is no guarantee that the final result would be satisfactory, precisely because when many parties are forced to come to an agreement, the resulting compromise is often less effective.

Lastly, if an EU Model Treaty is considered to be a suitable solution; a Multilateral EU Tax Treaty solution, which would require the removal of all existing treaties, would most likely be found to be disproportionate according to the EC principle of proportionality.

The EU Model Treaty would essentially be a Community version of the OECD Model, meaning that it would be based on the OECD Model but with the changes necessary to ensure compatibility with Community law. The Member States could then use the EU Model when concluding tax treaties with each other. This solution seems to be the one favoured by the Commission, who judges it to have the highest probability of success. There are different views on what form such a Model should have. Suggestions have ranged from including the provisions in a recommendation from the Commission to negotiating the Model Treaty between the Member States under Article 293 EC.

There seems to be a consensus that an EU Model should only contain the provisions necessary in order to comply with EC law. This is because such a “limited” Model would require less time and effort to negotiate, and would also retain some of its flexibility.

To what degree Member States would be allowed to derogate from the EU Model is an issue that would have to be addressed. On the one hand, if it was entirely up to the Member States on whether to follow the recommendations of the Model or not, it would clearly lose a great deal of its effectiveness in combating the problems brought up in this thesis. On the other hand, if there was an obligation on the Member States to follow the Model, it could be argued that it would lose some of its status as a “model”.

There are three kinds of provisions that would have to be adjusted to fit in an EU framework and included in the Model. The first is provisions regarding the definition of specific concepts, the second is substantive rules and the third is rules related to conflict resolution.

Among the arguments in favour of an EU Model Tax Treaty, the most compelling are how it would be “less disruptive” when compared to a Multilateral EU Tax Treaty, and thereby more proportionate. The EU Model would not require the tearing up of all existing tax
treaties between the Member States but instead supply a framework that would fit “on top” of the existing tax treaty network, allowing for strictly bilateral concerns not in danger of being found in breach of EC law to be reflected in the individual treaties. At the same time, the work load required to produce the EU Model Tax Treaty would most likely be significantly less than the Multilateral EU Tax Treaty.

As for the arguments against an EU Model Tax Treaty; they have already touched upon and are primarily the problems in deciding on what form the Model should have, as well as to what degree it should be binding on the Member States. Other issues that should be kept in mind are the need for a committee which would work with keeping the model up to date, the possible problem with whether or not the OECD would take issue with the EU Model, and finally problems related to the EC principle of loyalty.

One problem facing both the Multilateral Treaty and the EU Model is the fact that decisions on direct taxation requires unanimous decisions from the Council. This means that any such actions from the community requires political consensus among the Member States. This could prove to be an obstacle on the path towards the harmonization of tax treaties within the EU.
5 Analysis

5.1 Introduction

In this chapter the findings of the entire thesis will be compiled and taken into context, together with the authors’ own opinions on tax treaties and EC law, as regards the three sub-areas of development, problems and solutions.

The following will be focused on the conclusions which can be drawn as regards each of the three areas. For detailed summaries on what has been written in this thesis, see the end of each of the preceding chapters.

5.2 Development

It is clear that the development in the field of direct taxation, which once was thought to be exempt from Community influence, over the years have shifted towards being more and more affected by EC actions. Today, regardless of the initial expectations or opinions of the Member States, direct taxation is an area of law where careful regard must be taken to EC rules and legislation.

The ECJ has, in a roundabout way, extended its competence to cover issues of the Member States’ national direct tax legislation, and will not hesitate to declare provisions of national laws in breach of EC law, if those provisions lead to discrimination in cross-border situations. The Court clearly has a vision for the inner market of the EU, and delivers its rulings in accordance with that vision.

It was inevitable that the Court would eventually turn its gaze onto the potentially discriminatory situations created by the bilateral tax treaties for the avoidance of double taxation that have been concluded between Member States.

However, as can be seen from the case law on the relationship between tax treaties and EC law, the ECJ has shown some restraint in these matters. Although the amount of cases in the area is limited in comparison to the vast amount of rulings on the purely unilateral provisions in the Member States’ national legislations, we believe that one can still make out a clear trend in the way the Court will approach these matters. The ECJ is aware of the, potentially devastating, impact on the tax treaty network that declaring a tax treaty provision to be incompatible with EC law, if that provision is found in a majority of the treaties between Member States. Since the OECD Model Treaty is the basis for most tax treaties currently in effect, the Court has shown a reluctance to rule against provisions which are based on the Model.

We are still only in the beginning of this development and more cases are to be expected. The problems encountered so far might only have been the proverbial tip of the iceberg. While it is a good thing that the ECJ is mindful of the effects its rulings could have on the existing tax treaties, the fundamental principles of the Community must be respected.

At this point in time, two differing interests stand against one another. On one side stand the integrity and functioning of the tax treaty network within the Union, the Member States’ wishes to retain autonomy in direct tax matters and protect their taxable base. One the other side stands the fundamental freedoms inherent in the EC Treaty, the ideas of
equal treatment and non-discrimination for all residents of EU Member States, and the functioning and further development of the inner market.

5.3 Problems

As we have shown in this thesis there are many possible problems in the field of double taxation in the EC. The ECJ has declared some treaty provisions to be incompatible with EC law, but there are still many questions left unanswered. The Court has also, in our opinion, in some of its judgments given rather cryptic reasons as support for its judgments. Unfortunately, this means that the rulings cannot give much guidance to the opinions of the ECJ.

As we have shown, there are many future problems regarding tax treaties, and the ECJ seems reluctant to be the institution that is going to create harmonization in this field. Even if these issues end up before the Court in the future, there is no guaranteeing at all that the ECJ is ready to disregard the political opinions of the Member States or the possible economic implications of its rulings.

At the moment the opinions of the Member States seem to be that harmonization in this field of law shall not be done by negative integration, if at all. This attitude from the Member States is regrettable since greater harmonization in the field of tax treaties and direct taxation as a whole would be a step towards creating a more effective and competitive inner market.

It must be said that the Court took the political views of the Member States into consideration in the ruling in the D case. The Member States were clearly worried about what would happen to their bilateral tax treaties if the Court had found that EC law prescribes a most-favoured-nation treatment in the field of tax treaties. However, it is probable that the Court overreacted to the perceived threat of the MFN principle. The principle would only have had a limited effect on the tax treaty network. The decision of the Court is in our view unfortunate, since it must continue to protect the inner market and help to create a level playing field for the businesses and citizens of the EU. If the Court goes on the defensive when it comes to tax treaties it can create a situation where Member States can use provisions in the treaties to create discriminatory situations. For instance, had the provision at hand in the D case been found in only Dutch national tax law, it would most probably been found to be discriminatory.

Since the Court has lately shown some reluctance to take decisions in the tax treaty area that can have vast political or economic ramifications it is not to be expected that the necessary development towards harmonization will come in case law. It is therefore important that a solution is reached, preferably through positive integration.

5.4 Solutions

Taking what has been established so far into account, it is clear that a solution is needed and that the ECJ alone can not bring about such a solution.

As the so called “alternative solutions” have been shown to have drawbacks that prevented them from being suitable long-term solutions to combat the problems in question, it comes down to a choice between the two main methods presented in this thesis, the Multilateral EU Tax Treaty and the EU Model Tax Treaty.
The Multilateral EU Tax Treaty, while an interesting option, is in our opinion not a suitable solution at this point in time. While such a treaty would bring about the greatest degree of harmonization, it would also be very difficult to negotiate, since the amount of provisions that would have to be agreed upon by the contracting Member States would be quite significant. Going the way of a “partial” multilateral treaty would be a way of alleviating these concerns, but would only be a temporary solution. In addition, there would be a major impact on the tax treaty network, forcing the Member States to tear up their existing treaties in favour of the new multilateral one.

We are then left with the alternative of an EU Model Tax Treaty. The Model has many advantages when compared to the Multilateral EU Tax Treaty. For example, it would be easier to reach an agreement on, since only the provisions necessary to comply with EC law would have to be included. The Model also retains the advantage of flexibility, as the existing treaties would have to be altered in certain respects, but could remain in force and still include provisions that reflect bilateral concerns but are not in danger of being precluded by EC law.

It is the authors’ opinion that the EU Model Tax Treaty would be a suitable solution to the problems brought on by the conflict between tax treaties and EC law. As we believe it would be an overall “less disruptive” option when compared to the Multilateral EU Tax Treaty, it is also the more proportionate of the two options. Also, it has the added advantages of being less hindered by procedural issues and leaving more freedom to the Member States to themselves conclude their tax treaties.

However, while the EU Model Tax Treaty is the best option at present, a solution involving a Multilateral EU Tax Treaty could prove to be worth exploring again at a later date, when harmonization in direct tax matters has progressed further within the EU.

5.5 Conclusion

We have in this thesis shown that there exists a conflict between tax treaties and EC law. At the heart of this conflict stand the opposing interests of the integrity of the tax treaty network existing between the EU Member States, and the protection of the fundamental freedoms central to the functioning of the Community inner market. The ECJ has been shown to be caught in between these two interests.

This conflict has spawned a number of problems, some which have been addressed by the Court and some which have not. Among the problems that have been brought up in proceedings before the ECJ is the one that relates to the application the MFN principle to tax treaties concluded between Member States. This thesis argues that the Court did not deal with this issue in a satisfactory manner. This inadequacy to deal with the problem is in itself a good example of why there is a need for a solution based on positive integration.

According to the findings of this thesis, the best solution and the one that would have the highest probability of success would be one based on the drafting of an EU Model Tax Treaty. This solution would be in line with the Community principle of proportionality and leave a considerable degree of freedom to the Member States’ own tax treaty negotiations, while still addressing the problems brought on by the conflict between tax treaties and EC law in satisfactory way.
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Appendice A: List of relevant EC Treaty Articles

Article 10 EC

Member States shall take all appropriate measures, whether general or particular, to ensure fulfillment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community. They shall facilitate the achievement of the Community’s tasks.

They shall abstain from any measure which could jeopardise the attainment of the objectives of this Treaty.

Article 12 EC

Within the scope of application of this Treaty, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited.

The Council, acting in accordance with the procedure referred to in Article 251, may adopt rules designed to prohibit such discrimination.

Article 39 EC

1. Freedom of movement for workers shall be secured within the Community.

2. Such freedom of movement shall entail the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment.

3. It shall entail the right, subject to limitations justified on grounds of public policy, public security or public health:

(a) to accept offers of employment actually made;
(b) to move freely within the territory of Member States for this purpose;
(c) to stay in a Member State for the purpose of employment in accordance with the provisions governing the employment of nationals of that State laid down by law, regulation or administrative action;
(d) to remain in the territory of a Member State after having been employed in that State, subject to conditions which shall be embodied in implementing regulations to be drawn up by the Commission.

4. The provisions of this article shall not apply to employment in the public service.

Article 43 EC

Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.
Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the state where such establishment is effected, subject to the provisions of the chapter relating to capital.

Article 48 EC

Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.

‘Companies or firms’ means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.

Article 46 EC

1. The provisions of this chapter and measures taken in pursuance thereof shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on grounds of public policy, public security or public health.

2. The Council shall, acting in accordance with the procedure referred to in Article 251, issue directives for the coordination of the abovementioned provisions.

Article 56 EC

1. Within the framework of the provisions set out in this chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.

2. Within the framework of the provisions set out in this chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited.

Article 58 EC

1. The provisions of Article 56 shall be without prejudice to the right of Member States:

(a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested;

(b) to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.
2. The provisions of this chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.

3. The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56.

Article 94

The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market.

Article 293 EC

Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals:

— the protection of persons and the enjoyment and protection of rights under the same conditions as those accorded by each State to its own nationals,
— the abolition of double taxation within the Community,
— the mutual recognition of companies or firms within the meaning of the second paragraph of Article 48, the retention of legal personality in the event of transfer of their seat from one country to another, and the possibility of mergers between companies or firms governed by the laws of different countries,
— the simplification of formalities governing the reciprocal recognition and enforcement of judgments of courts or tribunals and of arbitration awards.