LIMITATION ON BENEFITS CLAUSES AND EUROPEAN COMMUNITY LAW: LEGITIMACY AND CONSEQUENCES

Alexander Greter[1]

***Abstract**: Limitation on Benefits clauses are an interesting and important topic as there might be frictions between European Law and other sources of International Tax Law. In a broad and general approach – rather than analysing a specific LOB clause – this article[2] will discuss whether the LOB-issue comes within the scope of the EC Treaty and in which situations concerning EU Member States and Third Countries a LOB situation and the EC Treaty might be relevant. It will be shown that in most cases free movement of capital (Art. 56 ECT) is applicable while in some circumstances other Freedoms may also be at issue. Furthermore the question of compatibility of LOB clauses with the EC Treaty will be addressed with the conclusion that most existing Limitation on Benefits clauses carry a certain risk of being declared incompatible with the EC Treaty. Last, but not least. this article deals with the legal consequences of a decision by the ECJ against a Member State and with the question as to what means exist on the level of the European Union if a Member State does not meet its obligations.*

I. Introduction

Limitation on Benefits clauses can be found in most Double Taxation Treaties (DTTs) of Member States (MS) of the European Union and possibly in most treaties of Non-EU-Members as well. The Limitation of Benefits clauses (LOBs) became a hot topic in the area of international tax law when the USA as an important economic force started to include them in their negotiations for DTTs. LOBs were

1 lic.iur. Alexander Greter has a Master of the University of Zürich, Switzerland, and is currently attending the London University LL.M Programme at King's College London. E-Mail: alexander.greter@bluewin.ch.

2 This article is based on material and cases available until 28 May 2007.

seen as means to combat treaty shopping.[3] This was 30 years ago.[4] These days, LOB clauses are the focus of interest again, but this time the reasons for that development lie on the other side of the Atlantic Ocean. The core point of the recent discussions of LOBs is whether they are – in the forms used at present – in conformity with the EC Treaty.

Although it is mainly tax lawyers from EU Member States who are interested in this question, it is also of importance for Third Countries (TC), i.e. Non-EU-Members, as the discussion also includes the clauses contained in DTTs between a MS and a TC.

This text deals with the question of conformity of Limitation on Benefits clauses with the EC Treaty and tries to show possible consequences if the above question is answered in the negative. Special emphasis is given to the situation of clauses included in DTTs with Third Countries.

Most DTTs of EU-MS broadly follow the OECD Model Convention (OECD-MC)[5]. The Model Convention includes a LOB clause in the Art. 10 on dividends. Similar clauses can be found in Art. 11 and 12 OECD-MC on the taxation of interest and royalties. These LOBs are short and general. Significantly different clauses are included in some DTTs between the USA and EU Member States: They are more sophisticated and try to give more certainty in relation to who falls under the clause and who does not[6], but the effect is the same for all taxpayers caught by these latter clauses as under the more simplistic clause in the OECD-MC.

Essentially, without going into detail on the wording and how the clauses operate, an LOB clause excludes taxpayers from treaty benefits if they are not the beneficial owner[7] of a certain payment received cross-border. That means that DTTs, i.e. the tax authorities applying the DTTs, treat taxpayers in one of the Contracting States differently if certain conditions are fulfilled. The different treatment may consist of different withholding tax rates or the taxation of one resident and the non-taxation of another resident. In a European Community context, this fact triggers thoughts that there might be an infringement of the fundamental freedoms as stated in the EC

3 M. Huber, M. S. Blum, "Limitation on Benefits under Article 22 of the Switzerland-U.S. Tax Treaty", Tax Notes international Aug. 8. 2005, p. 550

4 US Model Treaty 1977.

5 OECD Model Convention on Income and Capital.

6 United States Model Income Tax Convention 1996, Art. 22.

7 The meaning of the expression „beneficial owner" is a topic of its own and is not dealt with in this text; for a recent UK case on the topic see *Indofood International Finance Ltd v JP Morgan Chase Bank NA London Branch*; see also Lee A. Sheppard, "Indofood and Bank of Scotland: Who is the beneficial owner?", Tax Notes International, February 5, 2007, pp. 406ff.

Treaty because this might amount to discrimination, defined by the ECJ as different treatment of like situations[8], or to restriction.

II. Infringement of the fundamental Freedoms

1. Does this issue fall within the scope of the EC Treaty?

LOBs can involve EU Member States in different ways as shown below. But the clauses can be relevant in the light of the EC Treaty only if at least one party of the DTT is a MS because the former only applies to rules/actions of Member states. Situations, where only the beneficial owner is within the Community, are not within the scope of the fundamental freedoms as the EC Treaty can apply only to legislation or actions of a Member State. The MS where the beneficial owner is resident is, however, not responsible for LOB clauses affecting its residents. In a schematic overview, the EC Treaty applies to the following situations, given that the first position is the source, the second position is the location of the receiver of a payment and the third position is the beneficial owner of a payment:

	Source State and first Contracting State	State of residence of the receiver and second Contracting State	State of residence of the beneficial owner
a)	TC	MS	TC
b)	TC	MS	MS
c)	MS	MS	MS
d)	MS	MS	TC
e)	MS	TC	MS
f)	MS	TC	TC

Fig. 1

It is clear that more countries can be involved but the relevant questions are always: who are the DTT parties and where is the beneficial owner resident. It does not matter whether a LOB clause similar to the one in the OECD-MC is at issue or if it is one following the US Model Convention (US-MC). In addition, both types of clauses essentially require a beneficial owner in one of the Contracting States whereby the US-type clauses, unlike the short LOB in the OECD-MC, deem this requirement to be fulfilled in certain situations[9].

8 *Finanzamt Köln-Altstadt v Roland Schumacker*, C-279/93, para. 30.

9 E.g. when the stock exchange test or one of the other tests are fulfilled.

i) Contracting States are two EU Member States

The question of scope is easy to answer in a purely intra-Community context, i.e. in case c) above: The European Court of Justice (ECJ) has repeatedly stated that although direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law[10]. Therefore, even concerning tax law, the EC Treaty is relevant for LOBs in DTTs between two MS if the beneficial owner of a payment is also in a MS. [11]

The same is true for case d) as the issue is also an intra-Community issue: the discriminating state (source state) is a MS and is the same state where the receiver is resident. The receiver of dividend payments cannot be denied the right of freedom of establishment or freedom to provide services just because the beneficial owner is resident in a TC. It should not be allowed to look through a person in determining the scope of the freedoms. The freedoms have been constructed with regard to the single market and the abolition of barriers within it. For that reason it makes sense to interpret the freedoms extensively in this situation.

It can be said that, as a result, a LOB clause in a case where both Contracting States are MS falls within the scope of each of the fundamental freedoms if the other factual conditions[12] are fulfilled, disregarding if the beneficial owner is a MS resident or not.

Care is necessary in relation to permanent establishments. A permanent establishment (PE) within the Community of a company resident in another MS is allowed to claim DTT benefits.[13] Transactions between such a PE and a resident of another MS may therefore fall under this title. PE's of TC-residents, in contrast, can usually not claim treaty benefits as they are usually not "persons" in the meaning of the DTT.[14] Such a situation can fall only under the following subparagraph.

---

10 *Finanzamt Köln-Altstadt v Roland Schumacker*, C-279/93.

11 *Elide Gottardo v Instituto nazionale della previdenzia soliale*, C-55/00, para. 33.

12 E.g. establishment is concerned, free movement of capital is concerned; for the interaction of the freedoms see 12 *Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht*, C-452/04, para 48 and *Test Claimants Thin Cap Group Litigation v Commissioners of Inland Revenue*, C-524/04, para 34.

13 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt*, C-307/97, para. 58.

14 Art. 3 (1)(a) OECD-MC.

ii) One of the Parties of the DTT is not an EU Member State

In cases a) and f) only one MS is involved. The question is whether this is still enough for the EC Treaty to be applicable or not. The only freedom to consider is free movement of capital which is the only one pertinent in relation to Third Countries. The wording in fact suggests that this freedom could be relevant in situations where only one EU-MS is involved:" …, all restrictions on payments between Member States and between Member States and Third Countries shall be prohibited." Accordingly the EC Treaty seems to be applicable to a LOB clause in a situation like the one described in cases a) and f). The ECJ, however, has restricted the scope of Art. 56 ECT insofar as it is not relevant if one of the other freedoms would be applicable in an intra-Community context. This has been held in the *Thin Cap* case[15] as well as in *Fidium Finance*[16]. In these situations the restriction of free movement of capital is merely "an unavoidable consequence" of the restriction on one of the other freedoms.[17] The other fundamental freedoms do not apply to case a) and f) as they do not confer rights to Third Countries[18].

Case b) above is similar to case a) but in contrast to the latter there are two MS involved here. Therefore a LOB in such circumstances could lead to restriction/discrimination of residents of a MS, namely the beneficial owner, through another MS. It has been stated above, that in principle only the two Contracting States should be relevant to determine the scope of each freedom. This is, though, only true where both Contracting States are MS and probably both states are in breach of the ECT. The circumstances at issue here have, however, been decided by the ECJ in the *Open Sky* cases[19] where the Court decided that freedom of establishment was applicable. Therefore, case b) is not only within the scope of Art. 56 ECT but also within Art. 43 and 48 ECT freedom of establishment and freedom to provide services. This interpretation is required in a single market context.

A closer look is needed to case e) where the LOB directly affects a person in a TC but the source state and the state of residence of the beneficial owner are MS as described in case e). For the same reasons given for cases a) and f) Art. 56 ECT would be applicable here. But the more interesting question is whether the other freedoms are equally applicable. This question should probably be answered in the negative. The freedom is not actually exercised within the Community but the

15 *Test Claimants Thin Cap Group Litigation v Commissioners of Inland Revenue*, C-524/04.

16 *Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht*, C-452/04.

17 See Christiana HJI Panayi, "The Protection of Third-Country Rights in Recent EC Case Law", Tax Notes International, February 19, 2007, p 259.

18 E.g. *Test Claimants in the FII GLO V Commissioners of Inland Revenue*, C-446/04, para. 165.

19 E.g. *Commission of the European Communities v United Kingdom*, C-466/98.

beneficial owner uses a structure which leaves the common market and has an income source within the community. E.g. a shareholder resident in MS2 holds shares in a company in TC which is parent of a dividend paying company in MS1. This cannot be seen as an application of the freedom of establishment.[20] The same is true for Art. 48 ECT where services are concerned. Consequently only free movement of capital is applicable in case e) and as stated above only under the condition that it is not merely an unavoidable consequence of the restriction on one of the other freedoms.

iii) Findings: Scope of the EC Treaty

It has been shown that the fundamental freedoms apply to LOBs only if one of the Contracting States is an EU Member State. All the freedoms are applicable where both Contracting States to a DTT are MS but only free movement of capital is applicable where this is not the case, save the situation where the state of residence of the receiver of a dividend payment and the state of residence of the beneficial owner are MS. To make a connection to the table above, the result can be illustrated as follows:

case	constellation	Art. 43/48 ECT	Art. 49 ECT	Art. 56 ECT
a)	TC-MS-TC	X	X	✓
b)	TC-MS-MS	✓	✓	✓
c)	MS-MS-MS	✓	✓	✓
d)	MS-MS-TC	✓	✓	✓
e)	MS-TC-MS	X	X	✓
f)	MS-TC-TC	X	X	✓

Fig. 2

2. Infringement of fundamental freedoms

i) Determination of the infringing Act

The effect of certain LOBs is that payments from one Contracting State to a resident of the other Contracting State are taxed more heavily if the beneficial owner does not himself have the right to use the treaty advantages. Usually a higher tax is levied in the source state in form of a higher rate of withholding tax. That means that an EU Member State exercises a hypothetically restrictive action only if it is the source state applying different withholding tax rates to residents of other states. Does that mean that there is no infringement of the EC Treaty where the source state is not an EU-MS? The case law of the ECJ indicates that this is not the right way to look at this issue. A DTT is always a bilateral agreement which requires the ratification of both states i.e. the source state and the state of residence of a taxpayer. A contracting

20 *Winfried L. Holböck v Finanzamt Salzburg-Land*, C-157/05, paras. 19 and 26-28.

EU Member State might be infringing the EC Treaty by ratifying such a DTT which is treating differently recipients of payments of which the beneficial owners are resident in the contracting Member State and those recipients of payments of which the beneficial owners are not resident there. This has been decided by the ECJ in the *Open Sky* cases[21] where the EC Treaty was applicable to agreements between the USA and EU Member States. As a result, the infringing act can be the application of different tax rates through an EU Member State if it is the source state. Especially where, however, the contracting EU-MS is not the source state the relevant action can be the ratification of a DTT which allows a Third Country to apply different[22] or restrictive treatment.

ii) LOBs: Discrimination and restriction

The EC Treaty prohibits discrimination on grounds of nationality. This is stated in Art. 12 ECT but priority is given to special provisions like, among others, the fundamental freedoms. Discrimination describes a different treatment of comparable situations or similar treatment of different situations.[23] In *Biehl*[24] the Court made clear that not only overt discrimination but also covert discrimination, which is not based on nationality but in reality affects nationals from other MS more likely than nationals, is prohibited. It is, however, in many cases difficult to find the right comparator and furthermore, the ECJ has stated in *Schumacker*[25] that a resident and a non-resident are not as a rule comparable. As the wording of the fundamental freedoms does not only intend to combat discrimination but restrictions in general, the Court relies more and more on the latter and skips the issue of discrimination.

LOBs have an impact on two levels. First, they have an impact on the recipient of a payment who is resident of a Contracting State but who is not the beneficial owner. Secondly, they have an indirect impact on the beneficial owner. The impact itself consists in a different treatment of the recipient depending on whether he is the beneficial owner and where the beneficial owner is located if he is not.

In a first instance it is analysed whether the effect on the recipient is contrary to the EC Treaty. In all the cases where at least one of the Contracting States is a MS, the possibility of a different treatment of a recipient of income may be a reason for a person (who is not beneficial owner, e.g. because it is a subsidiary) not to invest

---

21 E.g. *Commission of the European Communities v United Kingdom*, C-466/98.

22 Georg W. Kofler, „European Taxation under an 'Open Sky': LOB Clauses in Tax Treaties Between the US and EU Member States", Tax Notes International, July 5 2004, p 52.

23 *Finanzamt Köln-Altstadt v Roland Schumacker*, C-279/93, para. 30.

24 *Klaus Biehl v Administration des Contributions du Grand-Duché de Luxembourg*, C 175/88, para. 13.

25 *Finanzamt Köln-Altstadt v Roland Schumacker*, C-279/93, para. 31.

money in the other Contracting State. Accordingly a LOB is an obstacle and therefore restricts the fundamental freedoms. Such an investment can be one that falls under free movement of capital, or, where both Contracting States are MS, it can also be an investment covered by the other freedoms as the other freedoms are restricted to intra-Community situations. On the level of the recipient, however, the LOBs do not amount to discrimination. A recipient not being the beneficial owner is treated differently only from other recipients who are resident of the same state. There is no differentiation between recipients of different states. However, a restriction of fundamental freedoms is given and this is enough for a rule to be contrary to the EC Treaty

Next, it has to be checked whether the impact on the beneficial owner infringes the fundamental freedoms. The LOB clauses allow the source state to apply different rules depending on whether or not the beneficial owner is resident. If the beneficial owner is not a resident in one of the Contracting States, the recipient and therefore indirectly the beneficial owner are treated less advantageously compared to the situation where the beneficial owner is resident in one of those states. This may inhibit a potential beneficial owner from structuring his investments in a certain way, e.g. to buy shares in a company of one of the Contracting States which derives income from the second Contracting State or to establish a subsidiary or a permanent establishment which has such income. This constitutes a restriction of the applicable fundamental freedoms[26].

Where the beneficial owner and the intermediary recipient are residents of two MS, there could even be discrimination instead of a mere restriction. In the most usual case, where the recipient is a company/subsidiary of the beneficial owner, we deal with a case similar to *Open Skies*[27]. Residents of a MS establishing themselves in another MS are usually in a comparable situation to the residents of the latter MS establishing themselves there.[28] They follow similar procedures and come under the same legal treatment which puts them in like positions. A denial of a tax benefit leads therefore to discrimination and infringement of the freedom of establishment.[29]

The situation is a bit more difficult where not establishments but other intermediaries are concerned. Both beneficial owners decide to exercise e.g. free movement of capital and invest via/transfer money to an intermediary person. This

---

26 See fig. 2.

27 Residents of other MS controlling a carrier in the contracting MS were treated differently because the US could deny the carrier the benefits of the Open Skies Agreement.

28 Not e.g. in ACT IV GLO mentioned below.

29 Cases resembling to these facts are *Commission v Kingdom of the Netherlands (ship registration)*, C-299/02 and *The Queen v Secretary of State for Transport, ex parte: Factortame Ltd and others* C-221/89 (Factortame II). In both the ECJ found the national legislation contrary to EC Law.

intermediary is treated generally the same independent of whether the beneficial owner is a resident of the same country or not. Where both beneficial – one resident of the contracting MS, the other of a different MS – take the same decision and this decision has in general the same legal consequences, i.e. the intermediary is taxed on his income, in the state where they have their effect, they have to be considered as being in a comparable situation regarding to their decision to interpose an intermediary person. The fact that one beneficial owner is resident of another MS does not influence the general treatment of the intermediary. As a consequence, the denial of a treaty benefit is a discriminatory act in relation to the beneficial owner who made the decision. In the *D* case[30] the ECJ has decided, that a person resident in a non-Contracting State is in a different situation than a person resident in a contracting MS. The difference is, though, that D has not exercised a freedom to come under the Belgian-Netherlands DTT and not made a transaction which was relevant under the Belgian-Netherlands DTT, whereas in LOB cases the beneficial owner exercises a freedom to come under the DTT in question and after that there is a DTT relevant transaction.[31]

As a result, it can be observed that LOBs are likely to cause discrimination or restriction of the fundamental freedoms as granted by the EC Treaty. It does not matter which type of Limitation on Benefit clause is at issue. The final effect of the OECD-type LOBs and of the US-type clauses is similar.

3. LOBs which do not lead to discrimination or restriction

Certainly not all of the above mentioned discriminations and restrictions are in breach of the EC Treaty. They can be justified as we will see below. But there are some cases, where LOBs do not discriminate or restrict. A recent case showing this issue is *ACT IV GLO*[32] where the DTT was drafted in a way which did not discriminate as the benefit in question was available to all recipients who were taxable in the source state but not to recipients who were not taxable in the source state. In the latter case there accordingly could not arise double taxation. Therefore the situations were not comparable and no discrimination resulted.[33] Whether a recipient was taxable was depending on the rights of the shareholder/beneficial owner in the treaty between the UK and his residence state. Where the beneficial owner was entitled to the tax credit in that treaty, the recipient in the Netherlands became taxable and where he was not entitled to the credit, the recipient became not

30 *D v Inspecteur van de Belastingdienst*, C-376/03.

31 Applied to D this would be the case if D had exercised e.g. the freedom of free movement of workers and moved to Belgium and then held real property in the Netherlands.

32 *Test Claimants in Class IV of the ACT Group Litigation*, C-374/04.

33 Tom O'Shea, "Dividend Taxation Post-*Manninen*: Shifting Sands or Solid Foundations?", Tax Notes International, March 5 2007, p. 905.

taxable in the UK. This LOB, however, did follow neither the OECD-MC nor the US-Model.

Where a discrimination or restriction exists in theory, they may possibly be healed through the DTT or another treaty in practice[34]. Where a Resident State applies the credit method and the increased withholding tax in the source state is lower than the tax rate in the state where the recipient (but not beneficial owner) is resident, there is no less advantageous treatment and therefore no restriction or discrimination. The same effect can be reached by a separate treaty. The Savings Tax Agreement between the European Union and Switzerland[35], which exempts – under certain conditions – dividends and other payments from the subsidiary to the parent from withholding tax, could serve as an example. Even if a DTT provision would cause a discrimination or restriction, the affected tax payer would not experience a disadvantage because he could use the Savings Tax Agreement to reach the desired result.

4. Possible justifications

The justification that seems to suggest itself in the given circumstances is the one brought forward in *Saint-Gobain*[36], the *D* case[37] and the *ACT IV GLO* case[38]. UK as the defendant in the *ACT IV GLO* case and some other governments put forward that, if the benefit from the DTT had to be extended to non-residents of other Member States, the equilibrium and reciprocity underlying the existing DTT would be undermined. They stated that each DTT is negotiated bilaterally and each party gives and receives some benefits. The ECJ has accepted these arguments and stated that benefits in a DTT are an integral part of the agreements and contribute to their overall balance.[39] It is not clear after this judgment whether this means that Member States are free to include whatever different treatment of non-residents in a DTT or not. Nevertheless, it seems not likely that Member States now have complete freedom to include arbitrary treatment of non-residents. The principle that in general

34 *Margaretha Bouanich v Skatteverket*, C-265/04, para. 56; also *Denkavit Internationaal BV and Denkavit France SARL v Ministre de l'Économie, des Finances et de l'Industrie*, C170/05, para. 46.

35 Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, OJ L 385, 29.12.2004, p. 30–49.

36 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt*, C-307/97.

37 *D v Inspecteur van de Belastingdienst*, C-376/03.

38 *Hanns-Martin Bachmann v Belgian State*, C-374/04, para. 80.

39 *Test Claimants in Class IV of the ACT Group Litigation*, C-374/04, para 88.

the law of Member States including DTTs has to be in accordance with the EC Treaty is long established and was explicitly stated by the ECJ in *Saint-Gobain*[40] where the argument of reciprocity was not accepted and the Court has ordered a unilateral extension of treaty benefits. The *Gottardo*- case[41] points in a similar direction and the same argument was also rejected. The circumstances were different in the *ACT IV GLO* case: the UK did not tax dividends paid by a UK-company if the beneficial owner was not entitled to the tax credit either under the DTT in question or under another DTT.

The argument of reciprocity of DTTs was also put forward by the Netherlands in the *D* case[42] and accepted by the Court[43]. But it is relevant in this case that D, falling under the Netherlands-Germany DTT, was asking for a benefit in the Netherlands-Belgium Treaty. This touches the issue of a most favoured nations principle rather than discrimination.[44] Although the MFN problematic includes some form of discrimination,[45] it is a different situation from that in LOB cases. LOB clauses in contrast deny a benefit to a person that actually is in the scope of the treaty but is treated differently because the beneficial owner is not. Therefore the *D* case argument cannot be applied directly to LOB situations.

Another justification, brought forward in most cases relating to tax is cohesion of the tax system as accepted by the ECJ in *Bachmann*[46]. But it seems difficult to support this justification and find arguments which could explain why the cohesion is in danger. In *Bachmann* there was a direct link between the tax allowance for insurance contribution and the taxation of payments made by insurers to residents, while such payments to non-residents were not taxable. Such a direct link however does not exist where withholding tax is reduced only for residents of the contracting Member State if the beneficial owner is also a resident there.

Last but not least, the justification of preventing tax avoidance could be relevant since the MS try to combat unjustified use of their tax treaty system. The ECJ has,

---

40 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt*, C-307/97, para. 57.

41 *Elide Gottardo v Instituto nazionale della previdenzia soliale*, C-55/00, para. 37.

42 *D v Inspecteuer van de Belastingdienst*, C-376/03, para. 48.

43 Ibid., para 61.

44 G. Kofler and C.P. Schindler, "Dancing with Mr D: The ECJ's Denial of Most-Favoured-Nation Treatment in the D case", European Taxation Vol. 45 (2005), pp. 531ff.

45 Tom O'Shea," The ECJ, the 'D' case, double tax conventions and most-favoured nations: comparability and reciprocity", EC Tax Review vol. 14 (2005), pp 190-201.

46 *Hanns-Martin Bachmann v Belgian State*, C-204/90 Para. 20

however, stated in *Cadbury Schweppes*[47] that an intention to optimise the tax structure cannot be seen as tax avoidance contrary to the EC Treaty if there are no objective circumstances showing that the objectives pursued by the freedoms have not been achieved[48]. Furthermore, the LOBs following the OECD-Models are quite general and not aimed at wholly artificial arrangements and at circumventing the application of the legislation of the Member State. The justification would therefore not pass the proportionality test. The US-type LOB clauses[49] are more specific and provide for several tests like the active trade or business test to ascertain that genuine intentions are exempted from the LOB. As a consequence, treaty benefits are granted if the recipient can show that he is exercising a business in his Resident State which is substantial compared to his activities in the source state. But still, the ECJ does not see Treaty Shopping per se as tax avoidance or abuse and therefore the US Model LOBs would also fail the proportionality test as it is yet too general and not all genuine intentions are covered by the exemptions.[50]

It follows that LOBs similar to the OECD-MC or the US-Model are contrary to the EC Treaty save in certain circumstances mentioned above[51]. The EU Member States infringe the Treaty either by treating taxpayers in similar situations differently themselves or by ratifying a DTT which allows a Third Country to do that. This result is in so far a delicate issue as it means that all the DTT of EU Member States following the OECD Model Convention or containing a LOB clause similar to the ones in the US Model are in breach of the EC Treaty.

III. Consequences of an infringement of the EC Treaty

1. Permission of LOBs through Art. 307 (1) ECT

The impact of the above result is narrowed by Art. 307(1) EC Treaty. This article allows Member States to continue applying agreements concluded before the date of their accession to the Community. For the founding MS, the relevant date is 1st January 1958, for the states that joined later their accession date. DTTs however are

47 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, C-196/04. Although Cadbury Schweppes was in relation to a intra-Community situation and an establishment case there is no reason why the same rules should not apply to free movement of capital and to cases where Third Countries are involved. If a taxpayer can show that there is in fact no wholly artificial arrangement there is also no space for additional justifications.

48 Ibid, para. 64.

49 See fn. 6.

50 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*, C-196/04, para. 63.

51 See II.3. above.

renegotiated regularly and most are not older than 30 years. While many treaties among the Western European countries were signed or amended at the end of the 1970s and beginning of the 1980s, DTTs with Eastern Europe and overseas countries usually are more recent. If we look at the UK as an example, we can see that the DTT UK-Germany was signed in 1964 and amended in 1970, the UK-Switzerland Treaty was signed in 1977 and amended in 1981 as well as in 1993 and that the UK-Czech Republic/Slovak Republic Treaty was signed in 1990. The UK joined the European Community in 1973. It follows that there are many treaties which are not saved by Art. 307(1) ECT and therefore infringe the EC Treaty if they contain LOBs as described above. In some cases, though, DTTs ratified after the accession to the European Community do not contain LOB clauses.[52]

Where Third Countries are involved and a DTT therefore has only to be checked in the light of Art. 56 ECT, the possibility of being contrary to the EC Treaty is still smaller. Following Art. 57(1) ECT, free movement of capital in relation to TC is only applicable from 1994 onwards.

On the other hand, Art. 307(1) ECT does not give an unlimited permission to uphold agreements containing clauses which are not in line with the EC Treaty if these Agreements were concluded before the accession to the European Community. Art. 307(2) ECT requires the Member States to take all appropriate steps to eliminate such incompatibilities. According to the ECJ's case law that means to renegotiate treaties containing clauses which are in breach with the fundamental freedoms or to terminate them.[53] If renegotiation is not possible or no result which is in line with the EC Treaty can be achieved, the Member State has the obligation to terminate an agreement.[54] However, Art. 307(2) ECT has to be interpreted in accordance with the principle of international law, i.e. Article 30(4)(b) of the 1969 Vienna Convention on the Law of Treaties, which says – applied to this situation – that duties of MS coming from older agreements with Non-EU-Member-States are not affected by the EC Treaty.[55] Therefore the obligation to terminate the argeement exists only where the agreement itself allows it. This is usually the case with DTTs[56] and therefore EU Member States can be forced to terminate DTTs which containd LOBs contrary to the fundamental freedoms if renegotiation is not possible.

---

52 DTT Germany-Czechoslovakia, signed 1980 (interestingly enough, the Germany-Estonia treaty, signed 1996 contains LOBs).

53 *Commission v. Portuguese Republic*, C-84/98, para. 58.

54 *Commission v Kingdom of Belgium*, C-170/98, para. 43.

55 *Attorney General v Juan C. Burgoa*, C-812/79, para. 8.

56 Art. 31 OECD-MC.

2. Enforcement of the obligations of the Member States

Where EU Member States are in breach of the EC Treaty – i.e. infringing one of the fundamental freedoms and not falling under the scope of Art. 307(1) ECT – the Commission as guardian of the Treaty can initiate infringement procedures[57]. If a MS, after the ECJ declared a LOB clause as contrary to the EC Treaty, does not eliminate the infringement, the Commission can take the case to the ECJ again. The Court can now, under Art. 228 ECT, order lump sum or penalty payments to enforce the fundamental freedoms.

If a Member State, however, continues to non-comply with its obligations and to eliminate LOBs which are contrary to the EC Treaty, the question arises whether this amounts to a serious and persistent breach of principles mentioned in Art. 6(1) of the Treaty on European Union[58] which would allow the Council to suspend voting rights and other rights of a MS under certain conditions given in Art. 7(2) and (3). The Commission indicates in a Communication[59] that only a breach of fundamental rights can activate Art. 7(3) of the EU Treaty. One of these rights is the rule of law which could be questioned if a MS does not comply with ECJ judgments. Furthermore the breach has to be a serious one. This is only the case when a breach is the result of a comprehensive political comportment and cannot consist in an individual breach. In addition, the Commission proposes criteria like the number and vulnerability of social classes affected to determine seriousness. Furthermore it has to be a persistent breach. A persistent breach can appear in different forms, for instance as piece of legislation or as an administrative practice. The Commission proposes the existence of several individual breaches or repeated condemnation by an international court or institution as possible criteria for determination of a persistent breach. While the list contains e.g. condemnation by the European Court of Human Rights, judgments by the ECJ are not mentioned there. In an overall perspective the Communication seems to show that non-compliance with an ECJ judgment is not enough if there is only a restriction of free movement of capital or one of the other freedoms by a tax law of a MS. Although it is a serious act by a MS and might ask for actions by the Community, it does not reach the level of an offence against principles like Human Rights or Democracy. The Principle of the Rule of Law is probably to read in a more fundamental way and might consist of the right to a fair trial stated in the ECHR[60] and the like. Therefore measures offered Art. 7(2) and (3) can probably not be adopted where an EU Member State does not follow the ECJ. However, the Commission has stated in the said Communication

57 Art. 226 ECT.

58 Consolidated versions of the Treaty on European Union and of the Treaty Establishing the European Community, Official Journal C 321E of 29 December 2006.

59 on European Union, COM(200359 Communication from the Commission to the Council and the European Parliament on Article 7 of the Treaty)606.

60 European Convention on Human Rights, Art. 6.

that the procedure is wholly political and not juridical. Therefore the answer given here is not carved in stone.

The above is equally true where a DTT is caught by Art. 307(1) ECT but the MS does not take the appropriate steps to eliminate incompatibilities as ordered by para. 2 of the same Article. The Commission may set time limits to take these steps and can address the case to the Court after time expired.[61] The core of the proceedings is the infringement of the specific fundamental freedom(s) which, after expiry of the time period set by the commission to take the necessary measures, is not permitted by Art. 307(1) ECT anymore. According to the wording of Art. 307(2) ECT there could also be an obligation on the MS to eliminate the infringement. If the MS does not take any steps to fulfil this obligation the infringement procedure could maybe also be based on an infringement of Art. 307(2) ECT.

VI. Conclusion

It has been shown that many LOB clauses found in DTTs at present are contrary to the fundamental freedoms as provided for in the EC Treaty. There is no justification available as the clauses usually are too general and do not fulfil the proportionality test. Therefore an EU Member State does infringe the fundamental freedoms either by treating a resident of the other Contracting State differently because of a beneficial owner of the payment who is not resident in that same state or by ratifying such a treaty with another state – including Third Countries – and therefore supporting discriminatory behaviour by that state.

Due to Art. 307(1) EC Treaty the LOB clauses in the treaties can still be applied, but the Member States have the obligation to renegotiate the treaties or – as an ultimate measure – to terminate them according to Art. 307(2).

The obligations of the Member States under the Treaty can be enforced by the infringement procedure initiated by the Commission. Non-compliance with a decision of the ECJ can lead to lump sum or penalty payments.

61 *Commission v Portuguese Republic*, C-84/98, para. 46.