AN ANALYSIS OF THE LIMITATION ON BENEFITS CLAUSE IN THE NEW US-MALTA DOUBLE TAXATION AGREEMENT

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Introduction

Tax law should not become a sort of legal 'wild-west' in which virtually every sort of opportunistic behaviour has to be tolerated so long as it conforms with a strict formalistic interpretation of the relevant tax provisions and the legislature has not expressly taken measures to prevent such behaviour.[2]

In a complex commercial globalized world involving sophisticated multinational enterprises, tax considerations will often form a main purpose for entering into an arrangement.[3] The lesser the tax liability on an international transaction, the more attractive the arrangement is. Consequently, tax mitigation opportunities are commonly sought in the international sphere. Cross-border taxation involving

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2 Case C-255/02 *Halifax and Others v Commissioners of Customs & Excise* [2006] ECR I-01609, Opinion of AG Maduro, para 77

3 Brian J. Arnold and Stef van Weeghel, 'The Relationship between Tax Treaties and Domestic Anti-Abuse Measures' in Professor Guglielmo Maisto (ed), *Tax Treaties and Domestic Law*, vol 2 (IBFD Publications 2006) 97

different state jurisdictions is governed by Double Taxation Conventions (hereinafter as 'DTCs').[4]

DTCs are bilateral instruments, entered into by two Contracting States with the objective of securing advantages for their *bona fide* residents on the basis of reciprocity.[5] The bilateral nature of these treaties and the reciprocity element allows only residents of the two Contracting States to be the legitimate beneficiaries of the tax concessions granted in the treaty.

Therefore, these tax treaties are useful tools in international tax planning operations to reduce taxation at source by deriving income from the state, which has entered into a treaty with the Source State where the non-resident tax liability is most reduced.[6] Accordingly, by incorporating a legal entity in the chosen state and attributing the income generated at source to this company to take advantage of the relevant DTT will cause the worldwide income to be liable to tax in that state.[7]

This international tax planning practice is a well-known concept called "treaty shopping" since a third country (hereinafter as 'TC') resident by means of a legal entity in either Contracting State can shop into the DTT even though the treaty was only meant for Contracting State residents. This "treaty shopping" phenomenon is described as 'consist[ing] in a resident of a state – which is not a party to a convention – establishing an entity within a state which is a party in order to take advantage of the provisions of that convention.'[8] Becker and Wurm describe "treaty shopping" as the practice where 'a taxpayer "shops" into the benefits of a treaty which normally are not available to him [and] to this end he generally incorporates a corporation in a country that has an advantageous tax treaty.'[9]

It is evident that the concept of "residence" is vital for the development of treaty shopping structures because a DTT is only applicable to persons who are residents in the chosen state according to the relevant treaty. "Residence" is defined in terms

4 The terms 'Double Taxation Convention' (referred as 'DTC'), 'Double Taxation Treaty' (referred as 'DTT') and 'Double Taxation Agreement' (referred as 'DTA') are used interchangeably throughout this study.

5 Tom O'Shea, *EU Tax Law and Double Tax Conventions* (1st edn, Avoir Fiscal Limited 2008) 192

6 Felix Alberto Vega Borrego, *Limitation on Benefits Clauses in Double Taxation Conventions* (Professor Peter HJ Essers and Professor Eric CCM Kemmeren (eds), 1st edn, Kluwer Law International 2006) 1

7 ibid 1

8 Philip Baker, *Double Taxation Conventions: A Manual on the OECD Model Tax Convention on Income and Capital* (Sweet & Maxwell 2001-) 1-2/16

9 Helmut Becker and Felix J. Wurm (ed), *Treaty Shopping: An Emerging Tax Issue and its Present Status in Various Countries* (Kluwer Law and Taxation Publishers 1988) 1

of taxing jurisdiction, where a person or an entity is considered resident in a state if that state asserts an unlimited right to tax one's income – that is, a right based upon the taxpayer's personal connection with the country, as opposed to the source of the income or any other factors.[10]

Generally, the use of a tax treaty by TC residents to obtain treaty benefits not available directly to them is lawful, as long as it is not prohibited by treaty provisions or general international law.[11] However, many countries consider such a practice as an improper use of tax treaties and thus unacceptable. Consequently, states include anti-treaty-shopping rules in DTTs designed to counteract it.

The purpose of this study is to examine these specific rules laid down in tax treaties, analysing in particular one type of rule, namely the Limitation on Benefits (hereinafter as 'LoB') clause, in view of the LoB article in the new DTC concluded between the United States (hereinafter as 'US') and Malta, which came into effect on 1st January 2011.

The US was the first country to detect the problem of treaty shopping and to deal with it. To this end, the US has unilaterally modified or terminated a number of its DTTs that were considered as prime vehicles for treaty shopping. The first treaty terminated for this reason was the US-Netherlands Antilles DTT on 29th June 1987 (effective as from 1st January 1988). As the Report drawn by the US Senate highlights, the previous 1980 US-Malta DTT was terminated by the US because it was concerned that:

> … recent changes in Maltese law inappropriately could facilitate use of the treaty by persons who are not residents of Malta or the United States. Under these circumstances, continuation of the treaty with Malta was not consistent with United States tax treaty policy.[12]

This termination took place in 1995 (effective as from 1st January 1997).

As a response to deal with the problem of treaty shopping, the US is the greatest proponent of the use of LoB clauses and in fact, it is the single state that has a strict policy of including such clauses in all of its treaties.[13] The purpose of the LoB clause is mainly to curtail treaty shopping by limiting the indirect use of a treaty's benefits by TC residents who are not intended to take advantage of those benefits. It is

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10 OECD Model Tax Convention on Income and on Capital, Article 4(1); United States Model Income Tax Convention, Article 4(1)

11 Andrea Amatucci (ed), *International Tax Law* (Kluwer Law International 2006) 179

12 US Treasury Department, 'U.S. Terminates Tax Treaty with Malta' (1995) 95 TNT 227-55

13 Ned Shelton, *Interpretation and Application of Tax Treaties* (LexisNexis 2004) 417

against this background that this article aims to examine the LoB clause inserted in the new US-Malta DTC as Article 22.

As the LoB clause is an anti-treaty-shopping measure, the concept of treaty shopping as an improper use of tax treaties will be examined in Part 1 considering the approaches undertaken by the OECD Model Tax Convention on Income and on Capital (hereinafter as 'OECD Model')[14] as well as that of the United States Model Income Tax Convention (hereinafter as 'US Model').[15]

The various paragraphs of the LoB article (Article 22) of the US-Malta DTT will be analyzed in Part 2 bearing in mind Article 22 of the 2006 US Model on the basis of which the LoB clause in the US-Malta DTC is based. An assessment of the various tests found in the LoB article in the US-Malta DTC will be undertaken in this part to explain how a resident of a treaty country may qualify for treaty benefits.

As Malta forms part of the European Union (hereinafter as 'EU'), necessitating national legislation to be compatible with EU law, Part 3 will examine the compatibility of the LoB clause in the US-Malta DTC with EU law. The compatibility or otherwise of such LoB clauses will be analyzed in the light of principles derived from jurisprudence of the Court of Justice of the EU (hereinafter as the 'CJEU').[16]

This study on the LoB clause in the US-Malta DTT has been undertaken to highlight the efficiency of this clause in preventing treaty shopping in the relations between US and Malta, which is essential for the dealings between these two economies. In fact, the coming into force of this DTC is fundamental for their commercial and diplomatic relationship as it is expected to generate further opportunities for cross border trade, commerce and investment between them, which is crucial for a small country like Malta.

PART 1 - TREATY SHOPPING AS AN IMPROPER USE OF TAX TREATIES

1. Introduction

Tax treaties themselves may become the object of tax avoidance activities, even though they often express the purpose of preventing tax avoidance.[17]

14 Paris, 22nd July 2010

15 15th November 2006

16 http://publications.europa.eu/code/en/en-390500.htm

17 Richard J. Vann, 'International Aspects of Income Tax' in Victor Thuronyi (ed), *Tax Law Design and Drafting*, vol 2 (International Monetary Fund 1998)

A typical "treaty shopping" situation involves TC residents accessing withholding tax rates provided in bilateral tax treaties, which are lower than those charged under domestic law in the absence of a treaty. Persons, whether individuals or companies would want to reduce their withholding tax liability when they invest in a country, which does not have a treaty with the taxpayer's country of residence. Consequently, investors, with the help of tax planning, may choose to structure their investment to fall under a specific tax treaty rather than another. In this regard, some forms of tax planning are considered as constituting abuse of tax treaties.[18]

As a result, in governmental and academic circles internationally, treaty shopping has been elevated to a prime example of improper use of tax treaties, which has to be eliminated.[19] Consequently, both the OECD as well as the US take a stand to curtail treaty shopping, even though they adopt a completely different approach to deal with this problem as can be seen in the analysis below.

2. OECD Approach

As outlined in the Introduction of this study, the US has been the leading proponent of international action to curtail treaty shopping.[20] Throughout the years, this problem has spread from the US to other OECD countries even though the development in these countries has been different.[21]

The OECD Model, which is the most widespread model, has identified the problem of "treaty shopping" implicitly in the discussion of "Improper Use of Tax Treaties" in its Commentary to Article 1[22] ever since the 1977 OECD Model. As stipulated by Professor Philip Baker, the principal problem aimed at in this section is that of "treaty shopping" – that is, use of a treaty by persons who are not themselves within the personal scope of the Convention.[23] Treaty shopping does not feature in the Model itself but is only included in the Commentary to Article 1. Nevertheless, the Commentary neither explicitly defines the concept of "improper use of tax treaties", nor does it clarify what proper use of tax treaties entails.

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18 Christiana HJI Panayi, *Double Taxation, Tax Treaties, Treaty-Shopping and the European Community* (Peter HJ Essers and Eric CCM Kemmeren (eds), 1st edn, Kluwer Law International BV 2007) 34

19 ibid 60

20 Brian J. Arnold and Michael J. McIntyre, *International Tax Primer* (2nd edn, Kluwer Law International 2002) 130

21 Becker and Wurm (eds), supra at 3

22 (2010) OECD Model, Article 1 deals with personal scope as it regulates *'Persons Covered'* under the DTC.

23 Baker, supra at 1-2/15

The principal purposes of a DTC are the promotion of international trade and investment through the elimination of international double taxation and the prevention of tax avoidance and tax evasion.[24] Thus by implication, any practice which promotes and furthers these purposes is considered as proper use of DTTs. Conversely, any practice going against these objectives would amount to improper use. In the absence of an express definition, the OECD Commentary provides an example to illustrate the concept of improper use of tax treaties as follows:

> a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly.[25]

This illustration resounds the concept of treaty shopping, even though it is not specifically referred to as such. The only instance where "treaty shopping" is mentioned in the Commentary to Article 1 is in paragraph 20, which deals with the Limitation-of-benefits provisions.[26]

3. US Approach

The term "treaty shopping" is a US concept, deriving from the term "forum shopping" used in US civil procedure to refer to the practice adopted by litigants to get their legal case heard in the court thought most likely to provide a favourable judgment.[27] David Rosenbloom[28] described this concept as:

> … the practice of some investors of "borrowing" a tax treaty by forming an entity (usually a corporation) in a country having a favourable tax treaty with the country of source – that is, the country where the investment is to be made and the income in question is to be earned. As a resident of the treaty partner, the entity may lay claim, in the absence of rules to the contrary, to the array of benefits accorded by the source country in the tax treaty.[29]

24 (2010) OECD Commentary to Article 1, paragraph 7

25 ibid para 9

26 The OECD Commentary uses the term "Limitation-of-benefits" whereas the US Model uses the term "Limitation on benefits". The two terms are synonymous. Thus, 'LoB' refers to both terms interchangeably whether it is referring to the OECD Model or the US Model.

27 Becker and Wurm, supra at 2

28 He was an International Tax Counsel in the US Treasury Department between 1977-1981.

29 David Rosenbloom, 'Derivative Benefits: Emerging US Treaty Policy' (1994) 22 Intertax 2, 83

Hence, the derivation to the term "treaty shopping" as it revolves around a person shopping into the benefits of an unavailable treaty through complicated structures set up solely for this purpose.[30]

As opposed to the 2006 US Treasury Department Technical Explanation (hereinafter as 'TE'),[31] this concept of treaty shopping was defined in the 1996 US TE as follows:

> A treaty that provides treaty benefits to any resident of a Contracting State permits "treaty shopping": the use, by residents of third states, of legal entities established in a Contracting State with a principal purpose to obtain the benefits of a tax treaty between the United States and the other Contracting State.[32]

Subsequently, this TE emphasized that:

> … this definition of treaty shopping does not encompass every case in which a third state resident establishes an entity in a U.S. treaty partner, and that entity enjoys treaty benefits to which the third state resident would not itself be entitled. If the third country resident had substantial reasons for establishing the structure that were unrelated to obtaining treaty benefits, the structure would not fall within the definition of treaty shopping set forth above.[33]

The 2006 US TE takes a different approach from the 1996 TE because it does not provide an express definition of "treaty shopping". Nonetheless, this US concept can still be deduced by analyzing the anti-treaty-shopping provisions that are provided for in Article 22. To this end, the 2006 TE provides that 'Article 22 contains anti-treaty-shopping that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries.'[34] This generic statement resounds very much the specific definition of treaty shopping found in the 1996 US TE, even though it follows more 'the current OECD trend of vague descriptions,'[35] delineated above. When comparing the US approach with the OECD approach in defining the concept of treaty shopping, it is quite ironic that the US, which is the leading proponent to object against treaty shopping, is moving towards more vague descriptions of the concept.

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30 HJI Panayi, supra at 36

31 This TE provides a common interpretation of the 2006 US Model. TEs drafted with each US DTT provides an explanation of the relevant treaty.

32 (1996) US TE, page 62

33 ibid 62

34 (2006) US TE, page 63

35 HJI Panayi, supra at 37

4. Conduit Structures

In a US case, called *Aiken Industries Inc. v Commissioner*,[36] the Tax Court denied an exemption from withholding tax under the US-Honduras DTT for interest paid to a base Honduran company because the latter did not have complete 'dominion and control' over the interest receipts but just mere physical possession on a temporary basis as it paid all the interest over to the Bahamian corporation, leaving it no profit on the transaction. Consequently, the Honduran corporation was merely considered as a conduit company for the purpose of moving interest payments between the US debtor and the Bahamian creditor.[37] As a result, the tax exemption under the DTT was not applicable as the only reason for establishing the Honduran company was to take advantage of the treaty.

In *Crown Forest Industries Ltd. v Canada*,[38] treaty shopping was described as an arrangement '… in which enterprises could route their income through particular states in order to avail themselves of benefits that were designed to be given only to residents of the contracting states.'[39] In this case, the Court held that the foreign corporation, which was incorporated in the Bahamas but carried on business in the US, was not US resident for treaty purposes.

These cases show that treaty shopping is commonly accomplished through what are known as "conduit structures". These are defined by the OECD Council as: '… a company situated in a treaty country is acting as a conduit for channelling income economically accruing to a person in another State who is thereby able to take advantage "improperly" of the benefits provided by a tax treaty.'[40]

Treaty benefits may be obtained either through "direct conduits" or "stepping-stone conduits".[41] The "direct conduit" structure refers to a situation where States X and Y have a DTC between them, enabling residents of State X to treaty benefits in relation to income and gains derived from State Y and vice-versa. State Z has no DTC with State Y but it has a DTC with State X granting residents of State Z benefits on income derived from State X. As a result, a resident of State Z incorporates a company in State X to take advantage of the X-Y DTC benefits. This company acts as an intermediary as the sole purpose behind its incorporation is to distribute its profits to the resident of State Z. This direct conduit structure in State X enables the

36 [1971] 56 TC 925

37 Anthony C. Infanti, 'United States' in Prof. Guglielmo Maisto (ed), *Tax Treaties and Domestic Law,* vol 2 (IBFD Publications BV 2006) 380

38 [1995] 2 S.C.R. 802

39 ibid 802 [52]

40 OECD Report, *Double Taxation Conventions and the Use of Conduit Companies* adopted by OECD Council on 27th November 1986, para 2

41 ibid para 4

resident of State Z to reduce the tax liability on the income or gains derived from State Y.

The "stepping stone conduit" structure is a variant of the direct conduit structure as it deals with a similar scenario, in that State Z does not have a DTC with State Y. The difference is that another state is involved since State Z has a DTC with State W. Suppose that in State X, charges from a foreign company are tax deductible and income from State Y is entitled to treaty benefits. Given these circumstances, the resident of State Z incorporates a company in State W, which derives its profits by providing services to its subsidiary company in State X. The subsidiary in State X realises its income in State Y to take advantage of the X-Y DTC benefits. Consequently, the profits are distributed at little or no tax cost from State Y to State W and then from State Y to the resident of State Z since the profits are subject to low or no taxation in State W.

Therefore, treaty shopping structures are put in place when the income is en route from the State of Source to the State of Residence[42] to make use of the exemption or reduction from tax in the State of Source through the use of the DTC concerned. This is where the LoB clause comes into the picture because the conduit company owned by the resident of State Z may still be denied access to treaty benefits by the LoB clause as this prescribes a number of tests to determine the eligibility or otherwise of the resident of State Z to claim such benefits. The LoB clause is designed to attack these conduit structures and thus, simply being a resident is not sufficient to obtain treaty benefits because 'the LoB clause makes the granting of benefits conditional on meeting further criteria designed to establish an economic nexus …'[43] with the State concerned.

5. OECD Approach vs. US Approach

The OECD Commentary to Article 1 does not offer a uniform solution in the form of specific and definitive methods to solve the problem of treaty shopping.[44] Nevertheless, it still provides a series of approaches, which can be adopted in DTTs to curtail this problem by limiting treaty benefits solely to *bona fide* residents of both Contracting States. These approaches, which were originally suggested in the 1986 OECD Conduit Companies Report,[45] include the look-through approach, the exclusion approach, the subject-to-tax approach and the channel approach.[46]

42 Vega Borrego, supra at 24

43 S. Sorensen and A. Suresh, 'Treaty Shopping and the New US-Netherlands Income Tax Treaty' (1993) J.I.B.L., 8(8), 309-313

44 Vega Borrego, supra at 90

45 OECD Report, supra

46 See OECD Commentary on Article 1 paras 13-18 for a description of these approaches, which are outside the scope of this study.

Although these approaches prevent treaty abuse, they can also limit benefits in genuine business transactions. Thus, the OECD Commentary recommends several *bona fide* provisions[47] to ensure treaty benefits for legitimate transactions that might otherwise be caught by these technical rules.[48]

The LoB clause adopts a channel approach combining an ownership requirement and a base erosion test.[49] This deals with the situation where only persons who are not acting as a conduit for channelling income or gains to a person not resident in either Contracting State will qualify for benefits under the treaty.[50] An alternative name for this approach is "base erosion" as it seeks to catch intermediary entities whose tax base is eroded in favour of third-country residents (usually controlling shareholders or associated persons) through the payment of interest or royalties or by the discharge of obligations.

Contrary to the OECD, the US considers that the most effective way to tackle treaty shopping is by the use of specific provisions in DTTs 'to preclude the misuse of beneficial treaty treatment by residents of countries not party to the treaty, i.e. third country residents.'[51] In fact, the US approach is to expressly identify which persons qualify for benefits by including specific provisions limiting treaty benefits to classes of taxpayers having a substantive connection with the treaty partner.[52]

This resulted in the US introducing and developing a comprehensive LoB article in most of its DTTs for the purpose of providing greater clarity regarding the persons who can qualify for DTC benefits, with the aim of preventing "treaty shopping" and eventually "tax avoidance".[53] According to Dr. Tom O'Shea, the LoB clause achieves its main function of determining which persons are entitled to DTC benefits by 'either defining the person entitled to the benefits (positive) or by excluding persons who do not meet certain defined conditions (negative).'[54]

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47 These are general *bona fide* provision, activity provision, amount of tax provision, stock exchange provision and alternative relief provision. See paragraph 19 of the OECD Commentary to Article 1 for a description of these provisions. There are only slight differences between these OECD provisions and the US LoB tests (examined in Part 2).

48 Vern Krishna with the assistance of Pamela Cross, *The Canada-U.S. Tax Treaty: Text and Commentary* (LexisNexis Canada Inc. 2004) 184

49 Luc de Broe, *International Tax Planning and Prevention of Abuse: A Study under Domestic Tax Law, Tax Treaties and EC law in Relation to Conduit and Base Companies* (IBFD 2008) 735

50 Angharad Miller and Lynne Oats, *Principles of International Taxation* (2nd edn, Tottel Publishing Ltd. 2009) 373

51 Miller and Oats, supra at 373

52 Amatucci (ed), supra at 211

53 O'Shea, supra at 193

54 ibid 193

Accordingly, the LoB clause provides certainty for taxpayers entering into treaty shopping transactions as it provides the requirements to qualify for DTC advantages.[55]

The LoB article is designed to prevent the creation of legal entities by residents of TCs to secure treaty benefits which the treaty partners did not intend to confer on them.[56] In fact, the purpose of the inclusion of these clauses is 'to guarantee that the benefits laid down in the convention are only conferred to those who are considered to have a legitimate claim thereto.'[57] Thus, the LoB clause limits treaty benefits only to *bona fide* residents, who have not set up enterprises in the State of Source for the sole purpose to claim treaty benefits.

6. Conclusion

The effectiveness of the LoB clause as an anti-treaty-shopping measure is evident by analysing its various provisions which shall be dealt with in the following part.

PART 2 – THE LIMITATION ON BENEFITS CLAUSE

1. Introduction

LoB provisions are '… aimed at preventing persons who are not resident of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of these States…'.[58] Nowadays, the LoB clause is a typical clause in most US DTTs, mirrored on the model LoB clause of the 2006 US Model (Article 22). Unlike the US Model, the OECD Model does not contain a specific LoB clause. Still, the OECD Commentary on Article 1[59] provides detailed LoB provisions, which are described as a 'comprehensive way' to deal with the issue of treaty shopping.[60]

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55 ibid 193

56 American Law Institute, *Federal Income Tax Project: International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties* (Philadelphia 1992) 127

57 Vega Borrego, supra at 14

58 (2010) OECD Commentary to Article 1, paragraph 20

59 See paragraph 20 of OECD Commentary to Article 1 for the detailed LoB article. The Commentary replicates the standard LOB clause found in the US Model. Therefore, no examination of the provisions of the OECD LoB clause is carried out in view of the following analysis of the LoB clause in the US-Malta DTC.

60 In discussing the LoB clause, reference is done to the US version of it despite the slight differences between the US and the OECD one as this study is done in the light of the LoB clause in the US-Malta DTC. Also, it is the US version of the clause that is actually reproduced in tax treaties with the US.

Although all LoB articles provided in different US DTCs are based on Article 22 of the US Model, the negotiations conducted by the US with the various States lead to variations in different LoB articles. In fact, many LoB articles are very long and detailed as can be seen from the analysis of Article 22 of the US-Malta DTT.

2. LoB Clause in US-Malta DTC

The extensive LoB article (Article 22) of the US-Malta DTC is structured along the same lines as the article in the US Model. Consequently, the TE of the US-Malta DTC mirrors the TE of the 2006 US Model.[61]

The US TE of the DTC between US-Malta[62] (hereinafter referred collectively as 'Contracting States') highlights the function of the LoB article '… as anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries.'[63] This article does not usually depend on 'a determination of purpose or intention'[64] but rather provides a number of objective tests which bring into force the application of the article. In fact, a resident of a Contracting State is eligible to receive treaty benefits if one of these tests is satisfied, irrespective of the motive for the establishment of the particular business structure.[65]

3. General Rule

The key function of Article 22 is to determine 'whether an entity has a sufficient nexus to the Contracting Sate to be treated as a resident for treaty purposes …'.[66] This is reflected in paragraph 1 which provides the general rule that a resident of either Contracting State deriving income from the other State is entitled in the State of Source '… to all the benefits of this Convention otherwise accorded to residents of a Contracting State[67] only if such resident is a "qualified person" …' and satisfies any other conditions provided in the DTC. However, this LoB clause does not

61 TE mentioned in this Part refers to the TE of the US-Malta DTC.

62 US-Malta DTC TE, 8th August 2008

63 ibid 60

64 ibid 60

65 An exception lies in the case of Maltese International Trading Companies, which are entitled to receive treaty benefits other than the benefits of Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 21 (Other Income) of the Convention.

66 US-Malta DTC TE, supra at 61

67 Benefits otherwise accorded to residents under the Convention include limitations on source-based taxation (Article 6 to Article 21), treaty-based relief from double taxation (Article 23) and protection afforded to residents under non-discrimination (Article 24).

restrict treaty benefits under all DTC articles since some provisions[68] do not require the person to be a resident of a Contracting State.

4. Qualified Person

The concept of a "qualified person" is the centerpiece of the LoB clause,[69] as the US approach has developed, via the LoB clause, the "channel approach" into the "qualifying person approach". Paragraph 2 lists a series of attributes, the presence of any one of which will automatically entitle a resident to all the treaty benefits, without any prior competent authority ruling or approval. These mechanical rules look solely at the characteristics of the person claiming such benefits and not at the nature of the activities. In fact, paragraph 2 is divided into six subparagraphs, each of which describes a different category of residents.

4.1 Individuals

Individual residents of both Contracting States are entitled to all treaty benefits.[70] Nevertheless, this does not apply where an individual acts as a nominee on behalf of a TC resident when receiving income, in which case 'benefits may be denied under the respective articles of the Convention by the requirement that the beneficial owner of the income be a resident of a Contracting State.'[71]

4.2 Government Entities and Other Public Agencies

The second subparagraph lists Contracting States, political subdivisions and local authorities as qualified residents eligible for all treaty benefits.[72]

4.3 Publicly Traded Corporations

The third group of qualified residents are publicly traded companies and subsidiaries of publicly traded companies.[73] Legal entities are only entitled to the benefits of the DTT, if in addition to being residents in one of the Contracting States, they have sufficient nexus with the State of Residence or a real business purpose to obtain the income generated in the State of Source from this State of Residence. These two criteria are specified in a number of clauses, which are explained below.[74]

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68 Article 25 (Mutual Agreement Procedure); Article 27 (Members of Diplomatic Missions and Consular Posts)

69 Krishna, supra at 184

70 US-Malta DTC, Article 22(2)(a)

71 US-Malta DTC TE, supra at 61

72 US-Malta DTC, Article 22(2)(b)

73 ibid Article 22(c)

74 Vega Borrego, supra at 3

4.3.1 Publicly Traded Test: Publicly Traded Parent Companies

A publicly traded parent company resident in either Contracting State is entitled to all treaty benefits if it satisfies four conditions, which are reproduced below:

a. its principal class of shares (and any disproportionate class of shares) is listed on a recognized stock exchange located in the Contracting State of which the company is a resident;

b. its principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident;

c. its principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; and

d. the company satisfies the requirements of clause (ii) of subparagraph (f)[75] of this paragraph.[76]

The rationale behind the publicly traded test is that persons wishing to set up a conduit arrangement are hardly likely to go to the expense of establishing and maintaining a company with a stock exchange listing for this purpose. If a company meets the requirements for a stock exchange listing it will be a company with substantial business activities.

However, to satisfy this test, such company needs to satisfy four secondary tests. The first relates to the term “recognized stock exchange” which means:

(i) the NASDAQ System and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934,

(ii) the Malta Stock Exchange, and

(iii) any other stock exchange agreed upon by the competent authorities of the Contracting States.[77]

The second secondary test refers to the term “principal class of shares”, which is defined to mean ‘the ordinary or common shares of the company, provided that such

75 Refer below to the explanation of base erosion test.

76 US-Malta DTC, Article 22(2)(c)(i)

77 ibid Article 22(8)(a)

class of shares represents the majority of the voting power and value of the company…',[78] that is that account for more than 50% of the shares of the company. In the absence of a single class of ordinary or common shares representing the majority, then the "principal class of shares" relates to the class or classes that represent collectively a majority of the aggregate voting power and value of the company.[79] Moreover, if the company only has one class of shares, it has to be determined whether this class can be considered as the "principal class of shares" and where the company has several classes of shares, the class or classes constituting the "principal class of shares" have to be ascertained.[80]

The third secondary test relates to the term "regularly traded", which is not defined in the US-Malta DTC. Pursuant to Article 3(2) of the DTC,[81] according to the US, a class of shares is considered to be "regularly traded" if trades in the class are made in more than *de minimis* quantities on at least sixty days during the taxable year, and the aggregate number of shares in the class traded during the year is at least ten percent of the average number of shares outstanding during the year.[82] According to the TE, trading on any recognized stock exchange or exchanges established in either Contracting States satisfies the requirement of "regularly traded".[83] Thus, trading is aggregated when it is done on more than one recognized stock exchange. As trading involves only the issued share capital of a company, the authorised share capital of the same company which unissued is disregarded in satisfying this requirement.

The fourth secondary test refers to the undefined term "primarily traded". Pursuant to Article 3(2) of the DTC, according to the US, stock of a corporation is "primarily traded" when 'the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the Contracting State of which the company is a resident exceeds the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.'[84]

Moreover, such a company would still be denied treaty benefits if it has a disproportionate class of shares that is not regularly traded on a recognized stock exchange, notwithstanding having the principal class of shares being regularly

78 ibid Article 22(8)(b)

79 ibid Article 22(8)(b)

80 US-Malta DTC TE, supra at 62

81 US-Malta DTC, Article 3(2): '… any term not defined therein shall, … have the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention applies …"

82 US Treas. Reg. Section 1.884-5(d)(4)(i)(B)

83 US-Malta DTC TE, supra at 63

84 US Treas. Reg. Section 1.884-5(d)(3)

traded on a recognized stock exchange. Article 22(8)(c) defines "disproportionate class of shares" as '… any class of shares of a company resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other State by particular assets or activities of the company.'[85]

4.3.2 Publicly Traded Test: Subsidiaries of Publicly Traded Companies

Subsidiaries of companies which satisfy the publicly traded test will normally also qualify for treaty benefits. In this case, benefits entitlement takes place 'if five or fewer publicly traded companies described in subparagraph 2(c)(i) are the direct or indirect owners of at least 75 percent of each class of the company's shares, and the company satisfies the base erosion test of subparagraph 2(f)(ii).'[86] The TE further provides that where the publicly-traded companies are indirect owners, each of the intermediate companies must be a resident of the same Contracting State that is also entitled to treaty benefits under subparagraph 2(c) (ii). However, if the publicly traded parent company were a resident of a third state (thus, not a resident of either of the two Contracting States), the subsidiary would not qualify for treaty benefits. Furthermore, if a Maltese parent company indirectly owns a company through a chain of subsidiaries, each such subsidiary must be Maltese resident entitled to treaty benefits in order for the subsidiary to meet the requirements of subparagraph (c) (ii).

4.4 Tax Exempt Organizations

Tax Exempt Organizations, which are described in Article 4(2) (b) of the DTC, are the fourth group of qualified residents.[87] Typical organizations qualifying under this category are those that are tax exempt in their State of Residence and that are set up exclusively for fulfilling religious, charitable, scientific, artistic, cultural or educational purposes.[88]

4.5 Pension Funds

Pension funds are another group of residents qualified for treaty benefits, provided that more than 75 percent of the beneficiaries, members or participants of the pension fund are individuals who are residents of either Contracting State.[89]

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85 US-Malta DTC TE, supra at 62

86 ibid 63 explaining US-Malta DTC, Article 22(2)(c)(ii)

87 US-Malta DTC, Article 22(2)(d)

88 US-Malta DTC TE, supra at 64

89 US-Malta DTC, Article 22(2)(e)

4.6 Ownership and Base Erosion Test

If any resident legal entity[90] fails to satisfy any of the above criteria under the "qualified person test", subparagraph 2(f) provides another method, consisting of a two-prong test, known as the ownership and base erosion test. For the resident to qualify under this subparagraph, both parts of the test have to be satisfied.[91]

4.6.1 Ownership Test

The first prong deals with the ownership test, which requires that at least 75 percent of each class of shares or other beneficial interests in the person is owned, directly or indirectly, on at least half the days of the taxable year by residents of that Contracting State who are entitled to the benefits of this treaty under subparagraph (2) (a), (b), (c) (i), (d), or (e). Nonetheless, in the case of indirect ownership, each intermediate owner is a qualified person that is also a resident of that Contracting State.[92]

Furthermore, the TE stipulates that trusts may be entitled to benefits under the ownership test if in addition to being residents according to Article 4 of the DTA, the beneficial interests in the trust will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust.[93]

4.6.2 Base Erosion Test

The second part of this test relates to a base erosion test which is complied with if less than 25 percent of the person's gross income for the taxable year, as determined in the person's State of Residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to the benefits of this Convention under subparagraphs (2) (a), (b), (c) (i), (d), or (e). This applies other than in the form of arm's length payments in the ordinary course of business for services or tangible property.[94]

5. Non-Qualified Person

Although the mechanical tests above-mentioned are useful in establishing that a taxpayer is not treaty shopping, they cannot be expected to account for every case in which a taxpayer has a valid business purpose for adopting a particular structure.[95]

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90 ibid Article 22(2)(f): 'a person other than an individual…'

91 US-Malta DTC TE, supra at 64

92 US-Malta DTC, Article 22(2)(f)(i)

93 US-Malta DTC TE, supra at 65

94 US-Malta DTC, Article 22(2)(f)(ii)

95 Ernst & Young LLP, *A Guide to the UK/US Tax Treaty* (LexisNexis 2003) 215

In fact, if a resident does not qualify under any of the above qualifying categories, the resident may still qualify for treaty benefits with respect to certain types of income under either the “derivative benefits test” or the “active trade or business test”.

5.1 Derivative Benefits Test

Paragraph 3 of the LoB clause provides a “derivative benefits test”, which although potentially is applicable to all treaty benefits, the test is applied to individual items of income.’[96] It stipulates that:

> Notwithstanding that a company that is a resident of a Contracting State may not be a qualified person, it shall be entitled to all the benefits of this Convention otherwise accorded to residents of a Contracting State with respect to an item of income if it satisfies any other specified conditions for the obtaining of such benefits …

As explained in the TE, ‘a derivative benefits test entitles a company that is a resident of a Contracting State to treaty benefits if the owner of the company would have been entitled to the same benefit had the income in question flowed directly to that owner.’[97]

Similar to the qualifying requirements of subparagraph 2(f), companies under paragraph 3 must satisfy an ownership test and a base erosion test. The ownership test is satisfied where at least 95 percent of each class of shares of the company have to be owned, directly or indirectly, by seven or fewer persons who are equivalent beneficiaries.[98] The term “equivalent beneficiary” is defined in paragraph 8(d) for the purposes of the LoB clause and this definition can be satisfied in two alternative ways.[99]

Furthermore, subparagraph 8(e) provides a special rule with respect to dividends, interest and royalties arising in Malta and beneficially owned by a US resident company, in view of the fact that Malta is a Member State (hereinafter as ‘MS’) of the EU. This rule stipulates that withholding taxes on inter-company dividends, interest and royalties are exempt within the EU by reason of various EU directives, rather than by the DTT. The insertion of this rule is essential, as many EU MSs may not have renegotiated their DTCs to incorporate the exemptions granted under EU Directives.

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96 US-Malta DTC TE, supra at 65

97 ibid 65

98 US-Malta DTC, Article 22(3)(a)

99 ibid Article 22(8)(d) for the technical rules of the term “equivalent beneficiary”.

The second test necessary to satisfy the derivative benefits test refers to the base erosion test provided for in subparagraph 3(b). This test is satisfied if 'less than 25 percent of the company's gross income for the taxable year in which the item of income arises is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries …'.[100] These amounts do not feature arm's length payments in the ordinary course of business for services or tangible property. The base erosion test in this provision is the same as the base erosion test in subparagraph 2(f)(ii), with the difference being that the test in subparagraph 3(b) focuses on base-eroding payments to persons who are not equivalent beneficiaries.[101]

5.2 Active Trade or Business Test

A main feature of conduit arrangements is channelling dividends, interest or royalties from one country to another. Persons wishing to take advantage of a DTT to which they are not properly entitled are unlikely to go to the trouble of setting up a fully active trading company in a foreign state just to save withholding tax. Thus, companies with an active trade or business are not usually regarded as conduit companies.

Failing to satisfy the "qualifying person test" and the "derivative benefits test" provided in paragraphs 2 and 3, paragraph 4(a) provides an alternative test called the "active trade or business test" under which a resident of either of the two Contracting States will be entitled to receive treaty benefits with respect to an item of income derived from the other Contracting State if 'the resident is engaged in the active conduct of a trade or business …' carried out in the State of Residence.[102]

Secondary tests must further be satisfied for this test to be met. Primarily, the item of income must be derived 'in connection with, or is incidental to,[103] that trade or business.'[104] Moreover, the resident must also satisfy the base erosion test provided in subparagraph 2(f)(ii).[105]

A key concept for this test is the term "trade or business". The TE provides that generally, 'a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise

100 ibid Article 22(3)(b)

101 US-Malta DTC TE, supra at 67

102 US-Malta DTC, Article 22(4)(a)(i)

103 The TE explains on page 70 that: 'An item of income derived from the State of source is "incidental to" the trade or business carried on in the State of residence if production of the item facilitates the conduct of the trade or business in the State of residence.'

104 US-Malta DTC, Article 22(4)(a)(i)

105 ibid Article 22(4)(a)(ii)

carried on for profit.'[106] Moreover, the TE notes that a corporation is considered to carry on a trade or business only if its officers and employees conduct substantial managerial and operational activities.[107]

An exception to this general rule in paragraph 4(a) relates to when the business involves the making or managing investments for the resident's own account.[108] However, there is an exception within the exception as the rule applies in the case of banking or insurance activities carried on by a bank or an insurance company acting in the ordinary course of their business.[109]

The TE clarifies that if the income-producing activity in the State of Source is a business that "forms a part of" or is "complementary" to the trade or business carried out in the State of Residence by the income recipient, then the item of income is considered to be derived in connection with the trade or business.[110]

A business activity conducted in one Contracting State will be considered to "form part of" another business activity conducted in the other Contracting State when the two activities involve 'the design, manufacture or sale of the same products or type of products, or the provision of similar services.'[111] With regards to the term "complementary", the activities do not have to relate to the same types of products or services, but they have to be part of the same overall industry. They also need to be dependent on each other, in that the success or failure of one activity will tend to lead to the success or failure for the other.[112] Where more than one trade or business is conducted in the State of Source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the State of Residence, it is necessary to identify the trade or business to which an item of income is attributable.

Where the trade or business generating the item of income is conducted either by the person deriving the income or by any associated enterprises, subparagraph 4(b) provides another condition to the rule found in subparagraph 4(a)(i). Under these circumstances, the carrying on of the trade or business in the State of Residence has to be "substantial" in relation to the trade or business activity in the State of

106 US-Malta DTC TE, supra at 68

107 ibid 68

108 ibid 68: A company that functions solely as a headquarters company is not considered to be engaged in an active trade or business for purposes of paragraph 4.

109 ibid page 68

110 ibid Page 68

111 ibid Page 68

112 ibid Page 69

Source.[113] The TE provides the purpose behind the substantiality requirement as being one of preventing 'a narrow case of treaty shopping abuses in which a company attempts to qualify for benefits by engaging in *de minimis* connected business activities in the treaty country in which it is resident (*i.e.*, activities that have little economic cost or effect with respect to the company business as a whole).'[114]

Moreover, in the case of an item of income derived by a resident of one of the Contracting States from a trade or business activity conducted either by that resident or by a related person in the other Contracting State, the conditions in subparagraph (a)(i) are satisfied 'only if the trade or business activity carried on by the resident in the first-mentioned Contracting State is substantial in relation to the trade or business activity carried on by the resident or such person in the other Contracting State.'[115]

This provision clarifies the concept of substantiality as follows:

> A trade or business will be deemed substantial if, for each of the three preceding taxable years, the asset value, the gross income, and the payroll expense that are related to the trade or business in the first-mentioned Contracting State each equals at least 10 percent of the resident's (and any related parties') proportionate share of the asset value, gross income and payroll expense, respectively, related to the activity that generated the income in the other Contracting State, and the average of the three ratios in each such year exceeds 15 percent.

The determination under this subparagraph is made separately for each item of income derived from the State of Source. Consequently, it can be the situation that a person is entitled to treaty benefits in relation to one item of income but not qualified with respect to another source of income.[116]

To complement the substantive rules in subparagraphs 4(a) and (b), subparagraph 4(c) provides special attribution rules, necessary to establish whether the requirements in subparagraphs 4(a) and (b) are met. Accordingly, these rules apply in determining whether the person is engaged in the active conduct of a trade or business and that the item of income is derived in connection with that active trade or business. These attribution rules also help in establishing the "substantiality" requirement.[117]

113 US-Malta DTC, Article 22(4)(b)

114 US-Malta DTC TE, supra at 70

115 US-Malta DTC, Article 22(4)(b)

116 US-Malta DTC TE, supra at 70

117 ibid 71

Subparagraph 4(c) attributes to a person activities conducted by persons "connected" to such person. For purposes of this subparagraph, 'activities conducted by persons connected to a person shall be deemed to be conducted by such person.'[118] This connection is confirmed if one possesses at least fifty percent of the beneficial interest in the other person. In the case of a company, the fifty percent relates to the aggregate vote and value of the company's shares or of the beneficial equity interest in the company. This connection is also established if another third person possesses this percentage in each person, whether it concerns an individual or a company. Therefore, such connection is generally established when one person has control of the other person or both are under the control of the same person or persons.[119]

5.3 Triangular Cases

Article 22(5) provides special rules governing the treatment of income in "triangular cases", regardless of the abovementioned provisions of the Article.[120] Such a context relates to the situation 'where an enterprise of a Contracting State derives income from the other Contracting State, and that income is attributable to a permanent establishment which that enterprise has in a third jurisdiction …'.[121] Hence the term "triangular" as it involves three structures: an enterprise of one Contracting State, an enterprise of the other Contracting state and the permanent establishment in a third state. In such a case, the tax benefits that are otherwise applicable under the DTC, will not apply to such income if the combined tax actually paid in the State of Residence and in the third jurisdiction is less than sixty percent of the tax that would have been payable in the State of Residence if the income were earned in that Contracting State by the enterprise and were not attributable to the permanent establishment in the third jurisdiction.[122] This provision is designed to discourage the use of branch financing structures where a resident enterprise is not taxed on the profits realized by a permanent establishment situation in a third state.[123]

An exception to this rule occurs in the case of dividends, interest and royalties, where the withholding tax rate shall not exceed 15 percent of the gross amount. Any other income applicable under this paragraph is subject to tax according to the domestic law of the State of Source, notwithstanding any other provisions of the DTC.[124]

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118 US-Malta DTC, Article 22(4)(c)

119 ibid Article 22(4)(c)

120 US-Malta DTC TE, supra at 71 gives an example of a triangular case.

121 US-Malta DTC, Article 22(5)

122 ibid Article 22(5)

123 O. Delattre, 'France-United States New Tax Treaty' (1995) 49 Bulletin for International Fiscal Documentation 65

124 US-Malta DTC, Article 22(5)

5.4 Competent Authority Discretion

If a resident of either of the two Contracting States fails to meet any of the tests laid out in paragraphs 1 to 5 of the LoB article, paragraph 6 provides a last resort mechanism of qualifying for treaty benefits at the determination of the competent authority of the Contracting State from which benefits are being claimed under this discretionary provision.[125] This discretion is described as a necessary "safety valve" for those situations where a company cannot meet the specified conditions of the LoB clause.[126] Consequently, this discretion prevents "treaty shopping" as the competent authority justifies the granting of DTC benefits to the relevant taxpayer.

In the absence of specifying the limits of discretion, one may consider such discretion to be quite broad. In fact, the TE stipulates that the competent authority may grant to the taxpayer either all the treaty benefits or it may confer only selected benefits.[127] Moreover, the competent authority may establish conditions, such as setting time limits on the duration of any relief granted.[128]

For a taxpayer to be able to benefit under this paragraph, a case needs to be presented to the relevant competent authority for a determination based on the facts. If the result is the determination that treaty benefits are permitted, 'they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.'[129] Furthermore, the TE gives the possibility of cases in which a resident of a Contracting State may apply for discretionary relief to the competent authority of his State of residence in the case where for instance, the benefit it is claiming is provided by the residence country and not by the source country.[130]

6. Remittance Basis of Taxation

Paragraph 7 addresses the application of the DTC where a remittance system of taxation is used as in the case of Malta's remittance system of taxation for individuals who are resident but not domiciled in Malta.[131] This system subjects persons to Maltese tax on foreign source income or gains only to the extent that such income or gains are remitted to or received in Malta and not by reference to the full

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125 US-Malta DTC, Article 22(6)

126 O'Shea, supra at 193

127 US-Malta DTC TE, supra at 72. For example, it may grant benefits only with respect to a particular item of income in a manner similar to paragraph 4.

128 US-Malta DTC TE, supra at 72

129 ibid 72

130 ibid 72

131 ibid 72

amount of income or gains. As a result, such persons are entitled to treaty benefits and to the tax relief only to the extent that the relevant income or gains are remitted to or received in Malta.[132]

7. Conclusion

This Part shows that a typical LoB provision sets a series of objective and subjective tests that are aimed at determining whether a resident has a valid business purpose for entering into a particular business structure or is merely attempting to participate in a treaty shopping scheme.[133]

> The assumption underlying each of these tests is that a taxpayer that satisfies the requirements of any of the tests probably has a real business purpose for the structure it has adopted, or has a sufficiently strong nexus to the other Contracting State (e.g., a resident individual) to warrant benefits even in the absence of a business connection, and that this business purpose or connection outweighs any purpose to obtain the benefits of the Treaty.[134]

Consequently, the presumption is that a taxpayer satisfying one of the aforementioned *bona fide* tests is not treaty shopping,[135] and thus, would be entitled to treaty benefits. To qualify for benefits, a resident of either Malta or the US is entitled to all treaty benefits only if one is a "qualified person" (paragraph 2). If a resident is not a "qualified person", benefits entitlement may be granted in respect of specific items of income, profits or gains under the "derivative benefits test" (paragraph 3), the "active trade or business test" (paragraph 4) or at the discretion of the competent authority of the country that is giving up its taxing right under the treaty (paragraph 6) in that respective order.[136]

PART 3 – THE LIMITATION ON BENEFITS CLAUSE AND EUROPEAN UNION LAW

1. Introduction

It is accepted international practice for LoB clauses to be very detailed and thorough as the clause of the US-Malta DTC. However, this does not remove any issues

132 ibid 72

133 Ernst & Young LLP, supra at 215

134 (1996) US TE, supra at 62

135 Ernst & Young LLP, supra at 246

136 ibid 247

which may arise when LoB provisions interact with EU law, which would not arise in a non-EU context. As a whole the LoB clause does not run counter to EU principles as one of the main objectives of the LoB clause in a DTC is to complement national rules dealing with "tax evasion", "tax avoidance" and "abuse of law".[137] However, in the specifics, greater scrutiny and examination of the LoB provisions in DTCs between EU MSs and TCs is needed to ensure that they are in compliant with EU law.[138]

2. Supremacy of EU Law

When EU MSs conclude international agreements, such as DTCs with other MSs as well as with TC residents, LoB clauses contained therein have to comply with EU law. This is a basic principle underlying international agreements entered into by EU MSs, which is highlighted by the CJEU in *Gottardo*[139] as follows:

> Member States must, when giving effect to commitments assumed under international agreements, be it an agreement between two Member States or between a Member State and a TC, comply with their Community law obligations, subject to coming within the exception provided by Article 307 ECT [Article 351 Treaty on the Functioning of the EU (hereinafter as 'TFEU'].[140]

Therefore, MSs are not just constrained by international tax law rules when concluding a DTC but EU norms and obligations must also be respected[141] since EU law has supremacy over the national rules of EU MSs. As a result, one cannot argue that a DTC between a MS and a TC falls outside the scope of EU competence because the EU does not have competence in relation to such DTCs. If the relevant DTC is not in compliant with EU law, it runs the risk of being in breach of EU law and thus would have to be amended or terminated.

3. Allocation of Taxing Jurisdiction vs. Exercise of Taxing Rights

As part of the MSs' competence to deal with "overlapping tax jurisdiction", MSs are allowed to 'base their agreements on international practice and the model convention

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137 O'Shea, supra at 195

138 ibid 195

139 Case C-55/00 *Elide Gottardo v Istituto nazionale della previdenza sociale (INPS)* [2002] ECR I-00413. This case dealt with an international convention on social security matters concluded between an EU MS and a TC.

140 ibid para 33. In relation to DTCs entered into by MSs prior to accession, Article 351 TFEU applies and the MS is obliged to either amend its DTS to make it compliant with EU law or to terminate the DTC.

141 O'Shea, supra at 116

drawn up by the OECD.'[142] This means that '… member states are at liberty … to determine the connecting factors for the purposes of allocating powers of taxation as between themselves'[143] and thus, to include LoB articles in their DTCs. However, 'as far as the exercise of the power of taxation so allocated is concerned, the MSs may not disregard Community rules.'[144] Thus, this must always be done fully complying with EU rules and EU obligations.

This distinction between these two powers is vital when analysing the interaction between the European Internal Market (hereinafter as 'EIM') and the LoB clauses in DTCs between a MS and a TC since MSs have to comply with EU law. Consequently, any examination of the extent of compatibility of LoB clauses in DTCs with EU law must take this distinction into account.

4. National Treatment Principle

As EU law has supremacy over national law, every DTC concluded between two MSs or a MS and a TC needs to comply fully with EU law. If a MS enters into a DTC with a TC for its own nationals' benefit, 'the fundamental principle of equal treatment requires that that MS grant nationals of other Member States who are in a comparable situation the same advantages as those which its own nationals enjoy under that convention unless it can provide objective justification for refusing to do so'.[145] This refers to the "national treatment principle", which is a fundamental principle inherent in EU tax law.

It is important to assess the compatibility of LoB provisions in DTCs with this national treatment principle by examining the CJEU's judgements relating in particular, to the freedom of establishment[146] and the free movement of capital.[147] The CJEU in *Commission v Germany ("Open Skies")*[148] cited *Saint-Gobain*[149] and stated with regards to the national treatment principle:

> Articles 52 and 58 of the Treaty thus guarantee nationals of Member States of the Community who have exercised their freedom of establishment and

142 Case C-336/96 *Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas-Rhin* [1998] ECR I-02793, para 31

143 Case C-307/97 *Compagnie de Saint-Gobain, Zweigniedeerlassung Deutschland v Finanzamt Aachen-Innenstadt* [1999] ECR I-06161, para 57

144 ibid para 57

145 *Gottardo*, supra para 34

146 Article 49 TFEU regulates freedom of establishment.

147 Article 63 TFEU regulates free movement of capital.

148 Case C-476/98 *Commission of the European Communities v Federal Republic of Germany ("Open Skies")* [2002] ECR I-09855

149 *Saint-Gobain*, supra para 35

> companies or firms which are assimilated to them the same treatment in the host Member State as that accorded to nationals of that Member State.[150]

The CJEU focused on this principle by stressing the need for EU MSs that:

> … as far as the exercise of the power of taxation so allocated is concerned, the Member States must comply with the Community rules … and, more particularly, respect the principle of national treatment of nationals of other Member States and of their own nationals who exercise the freedoms guaranteed by the Treaty.[151]

Therefore, this "national treatment" principle requires each EU MS to grant to nationals of other MSs exercising their fundamental freedoms, no less favourable treatment than it grants to its own nationals, in situations where such persons are comparable[152] unless objectively justified. This "no less favourable treatment" applies also in the case of benefits available under international agreements and this can be evident from *Matteucci*.[153] This case dealt with a bilateral cultural agreement between Belgium and Germany under which educational scholarships were granted. Matteucci was an Italian national seeking to access the benefits of the cultural agreement as she had acquired free movement of worker rights, her family having settled in Belgium. Thus, Belgium was obliged to grant to Matteucci, no less favourable treatment than that given to Belgian workers.[154]

Accordingly, EU MSs cannot enter into a DTC which contains a LoB clause in breach of this national treatment principle unless a proportionate justification concerning a general interest is given.[155]

5. LoB Tests vs. EU Principles

As regards individuals, government entities and other public agencies, LoB clauses cause no compatibility issues since all of them are entitled to treaty benefits without distinction.

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150 *Commission v Germany ("Open Skies"),* supra para 148

151 Case C-385/00 *F.W.L. de Groot v Staatssecretaris van Financien* [2002] ECR I-11819, para 94

152 Persons are in a comparable situation when nationals of the MS are exercising their fundamental freedoms like nationals of other MSs.

153 Case C-235/87 *Annunziata Matteucci v Communaute francaise of Belgium and Commissariat general aux relations internationales of the Communaute francaise of Belgium* [1988] ECR 05589

154 ibid para 16

155 O'Shea, supra at 201

The same cannot be said as regards companies. The several LoB tests provided in the US-Malta DTC examined in the previous part are based on the company's nationals and/or resident owners and shareholders.[156] In fact, to be eligible for treaty benefits, companies are required to have owners or shareholders who are residents of one of the Contracting States. In the EIM where fundamental freedoms are the basis of its operation and function,[157] the condition of granting DTC benefits on the basis of residency or nationality may cause friction because no discrimination or restriction of fundamental freedoms is allowed under EU law unless objectively justified.[158] Consequently, the applicability of DTC benefits to certain nationals and residents may be to the detriment of nationals and residents of other EU MSs who are excluded from the relevant treaty benefits by the LoB clause.[159]

The inclination towards preferring companies incorporated in the Contracting States over companies set up in other EU MSs occurs even when considering the various tests provided in the LoB clause as has done José Calejo Guerra in his article called *Limitation on Benefits Clauses and EU Law*,[160] whose analysis will be reproduced below.

The "publicly traded test"[161] amounts to indirect discrimination on the basis of nationality both in regard to the freedom of establishment and the free movement of capital because usually, a public company is eligible for treaty benefits under this test if it has its shares traded on the stock exchanges of the Contracting MSs and not just any stock exchange in any EU MS. The discriminatory treatment is also present when considering that the test fails if the shareholding is lower than that established in the LOB clause. Furthermore, the shareholders need to be resident in one of the Contracting States. In the US-Malta DTC and in a number of DTCs concluded between the US and EU MSs, the term "recognized stock exchange" also means any other stock exchange agreed upon by the competent authorities of the Contracting States which in theory helps remove this discrimination as it can include all EU stock exchanges. Nevertheless, this has to be determined by the relevant competent authorities.

The ownership requirement in the "ownership and base erosion test"[162] also seems to amount to indirect discrimination on grounds of nationality. However more analysis

156 ibid 195-196

157 The fundamental freedoms most relevant for this study are the freedom of establishment and free movement of capital.

158 Justifications are not part of this study.

159 O'Shea, supra at 196

160 José Calejo Guerra, 'Limitation on Benefits Clauses and EU Law' (2011) IBFD European Taxation 85

161 ibid 89-90

162 ibid 90

in relation to this test is found in Sections 6, 7 and 8 below. As is evident from Part 2 above, the aim of the base erosion test is to curtail abusive structures where income flows through the entity and deductions are used to reduce the income in one state in favour of a resident in another state. In this respect, the CJEU has never accepted loss of tax revenue as justification for discrimination.[163] The same analysis applies to the "derivative benefits test"[164] which features both these tests.

The "active trade or business test"[165] rejects benefit entitlement where the income is derived in connection with a business carried on in another MS that is through a permanent establishment in another MS. According to the CJEU, this is incompatible with the freedom of establishment since Article 49 of the TFEU stipulates that restrictions on the freedom of establishment of nationals of a MS in the territory of another MS are prohibited and this applies also 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.' The CEJU in interpreting freedom of establishment states that it does not require the business (or part of it) to be carried out in the MS of establishment so long as there is an effective establishment and not an artificial structure since this would go against the functioning of the single market. Furthermore, in the second part of this test, it incorporates an irrebuttable presumption of treaty shopping when it focuses on the level of economic involvement in the residence state as compared to the source state. As stated in *Cadbury Schweppes*,[166] such presumptions are not in accordance with EU law unless they only cover 'wholly artificial arrangements'.[167]

In addition, the "competent authority determination"[168] provisions in DTCs may also be conflicting with EU's principles because their discretionary nature may not always comply with EU's national treatment and legal certainty principles.[169]

Consequently, contrary to the philosophy of the EIM, the LoB clauses create 'protectionist barriers in favour of businesses established in the DTC MS to the detriment of businesses established in other MSs who may be denied DTC benefits despite being in a comparable situation.'[170]

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163 *Saint-Gobain,* supra para 50; Joined Cases C-397/98 and C-410/98 *Metallgesellschaft Ltd. a.o. v Commissioners of Inland Revenue, H.M. Attorney General* [2001] ECR 1-1727, para 59

164 Calejo Guerra, supra at 92

165 ibid 91

166 Case C-196/04 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I-07995, para 51

167 ibid para 68

168 Calejo Guerra, supra at 92

169 O'Shea, supra at 197

170 ibid 196

6. "Nationality" LoB Clauses and EU Fundamental Freedoms

The analysis of the LoB clause found in DTCs concluded between the US and an EU MS, deserves special attention in the light of the CJEU's *"Open Skies"* judgements which deal with air transport agreements (hereinafter as 'ATAs'), containing LoB provisos restricting benefits on the basis of "nationality clauses".[171]

This litigation arose as a result of infringement proceedings brought by the European Commission to challenge these ATAs entered into by several EU MSs with the US because of a "nationality" provision in the LoB clause. In one of these cases, *Commission v Germany ("Open Skies")*, the European Commission argued that the ATA between US and Germany was incompatible with EU law because it contained a LoB clause, whose "nationality clause" conflicted with the freedom of establishment principle under EU law. As highlighted by the CJEU, this LoB clause:

> … on the ownership and control of airlines does, amongst other things, permit the United States of America to withdraw, suspend or limit the operating authorisations or technical permissions of an airline designated by the Federal Republic of Germany but of which a substantial part of the ownership and effective control is not vested in that Member State or in German nationals.[172]

The consequence of this LoB clause was a potential denial of national treatment to airlines owned in the majority by nationals of MSs other than Germans.[173] These authorisations and permissions may be revoked, suspended or limited where the above condition is not fulfilled.[174]

Thus, airlines established in Germany of which a substantial part of the ownership and effective control is vested either in another EU MS other than Germany or in nationals of such a MS can be affected by this LoB clause.[175] According to the CJEU, the direct source of the discrimination arose from the LoB clause itself, which allowed the US to act in this discriminatory way,[176] that is rejecting benefits to airlines substantially owned by nationals of MSs other than Germany, while granting benefits when a substantial part of the ownership and control was vested in German nationals.[177] Consequently, this discrimination was against Community

171 ibid 199

172 *Commission v Germany ("Open Skies"),* supra para 150

173 O'Shea, supra at 205

174 1955 Germany-US ATA, supra Article 4 as amended by the 1996 Amending Protocol

175 *Commission v Germany ("Open Skies"),* supra para 151

176 O'Shea, supra at 205

177 *Commission v Germany ("Open Skies"),* supra para 152

airlines, except German ones, by preventing the former from benefiting from the same national treatment accorded to the latter.[178] This resulted in a breach of the national treatment principle, because the relevant MS concluded a DTC with a LoB clause restricting fundamental freedoms.

The prevailing opinion in the tax literature is that, although the *"Open Skies"* cases concerned a totally different area of law, namely transport, which is much more harmonized than direct taxation, the reasoning in these cases is useful for tax purposes and for interpreting the compatibility of LoB clauses with the fundamental freedoms.[179] This is because LoB clauses discriminating on grounds of nationality are contrary to the freedom of establishment and thus incompatible with EU law.

The compatibility of "nationality" LoB clauses with the national treatment principle can also be examined in the light of the *Factortame*[180] and *Commission v Netherlands ("Dutch Ship Registration")*[181] judgements as these also involved nationality clauses.

Factortame cases involved "quota-hopping", a concept analogous to treaty shopping, as fishing quotas of a MS are plundered by vessels flying the respective MS's flag but lacking any genuine link with that MS. In these cases, which dealt with UK legislation relating to the registration of fishing vessels, the CJEU held that it constituted nationality discrimination for a MS to impose as a condition for the registration of a fishing vessel that its legal and beneficial owners, charterers, managers and operators and, in the case of a company, the shareholders[182] and directors[183] to be nationals of the flag State, resident and domiciled in the flag State.[184] Although the competence to determine the conditions for the registration of fishing vessels on the national shipping register rested with the MSs, they still had to comply with EU law. Consequently, this condition breached EU law as it infringed the freedom of establishment.[185] These cases are in line with the *"Open Skies"*

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178 ibid para 153

179 Michael Lang, Josef Schuch and Claus Staringer, *Tax Treaty Law and EC Law* (Kluwer Law International 2007) 326

180 Specifically *R. v Secretary of State for Transport, ex parte Factortame Limited and Others; Regina v. Ministry of Agriculture, Fisheries and Food ex parte. Agegate Ltd.; Regina v. Ministry of Agriculture, Fisheries and Food ex parte. Jaderow Ltd. and Others*

181 Case C-299/02 *Commission of the European Communities v Kingdom of the Netherlands* [2004] ECR I-9761

182 At least 75% of the shares in the company.

183 At least 75% of the directors of the company.

184 Case C-213/89 *R. v Secretary of State for Transport, ex parte Factortame Limited and others* [1990] ECR I-02433, para 6

185 Case C-221/89 *R. v Secretary of State for Transport, ex parte Factortame Limited and others* (Factortame No 2) [1991] ECR I-03905, para 32

judgments as the same reasoning applies to "nationality" clauses in LoB provisions of DTCs.

In *Commission v Netherlands ("Dutch Ship Registration")*,[186] Dutch ship registration rules were challenged as being incompatible with the freedom of establishment of shipowners because they needed persons responsible for the day-to-day management, the directors and a proportion of the shareholders of the ship-owning company to be of EU or European Economic Area (hereinafter as 'EEA') nationality.[187] This case shows that even the use of the term "EU/EEA nationals" as part of the LoB clause can cause a restriction of the freedom of establishment. This is clarified by the CJEU in paragraph 24:

> … while conditions of Community or EEA nationality might be accepted in the context of a harmonised Community scheme, they cannot be established unilaterally by MSs in their national rules.

The *"Open Skies", Factortame* and *Dutch Ship Registration* judgments show that LoB clauses containing diverse "nationality" conditions featured in the jurisprudence of the CJEU. In each of these cases, the CJEU noted that these "nationality" requirements were in breach of the freedom of establishment. Consequently, the MS entering into such agreements was in breach of its obligations under EU law.

7. "Residency" LoB Clauses and EU Fundamental Freedoms

The LoB clause can also interact with the national treatment principle in a case involving a "residency" clause similar to the LoB article found in the UK-Netherlands DTC discussed in the *ACT IV GLO*[188] litigation. This case, which concerned the UK's tax rules on dividend payments made by a UK resident company to its shareholders resident in other EU MSs or TCs, dealt with an outbound dividend situation in the light of the LoB clause (Article 10) of the UK-Netherlands DTC.

According to UK tax rules, a tax credit was granted if the ultimate shareholders were UK residents or residents in an EU MS having a DTC with the UK granting the benefit of the tax credit on a full or partial basis. This tax credit was not granted if the shareholders were companies resident in an EU MS having no DTC with the UK granting such tax credit.[189] As a result, the UK-UK situation was treated differently from the UK cross-border situation unless a UK DTC provided otherwise.

186 Case C-523/04 *Commission v Netherlands* [2007] ECR I-3267

187 ibid para 19

188 Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue* [2006] ECR I-11673

189 ibid para 30

The CJEU noted that this UK tax rule affected the freedom of establishment and the free movement of capital, depending on the nature of the holding in the UK company.[190] The point of contention in this case was the LoB clause in some of the UK's DTCs, which

> … does not grant a tax credit to a company resident in the other contracting Member State if that company is controlled by a company resident in a third State with which the first Member State has concluded a DTC which, when dividends are paid, makes no provision for a tax credit for a company which is resident in a third country and receives the dividends …[191]

Therefore, UK's tax rules differentiated between two Dutch companies receiving a dividend from a UK resident company on the basis of the residency of the beneficial owner of the Dutch company. The tax credit was granted if the Dutch company was controlled by Dutch residents, while declined if the Dutch company was controlled by a resident in another EU MS with which the UK has no DTC granting such credit.[192]

Prima facie, this different treatment seems discrimination by both the Netherlands and the UK. In conducting a comparability analysis, the Court noted that where pursuant to a DTC, the UK grants a tax credit to a Dutch resident company which receives dividends from a UK resident company, the UK also retains the right to tax this Dutch company on these dividends.[193] Therefore, there is a direct link between the entitlement to a tax credit and the liability to tax under such DTC.[194] In relation to the other Dutch company owned by non-Dutch resident company, no tax credit was granted but the UK also exempted the dividend payments. It was only in relation to the first Dutch company that the UK had to extend a tax credit because that Dutch company was entitled to national treatment in the UK.[195]

Thus, 'a company resident in a member state which has concluded a DTC with the UK which does not provide for such a tax credit is in a different situation as a company resident in a member state which has concluded a DTC which does provide for one',[196] because whereas the latter incurred double taxation, the former

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190 ibid para 38

191 *ACT IV GLO,* supra para 76

192 O'Shea, supra at 209

193 ibid para 87

194 ibid para 87

195 O'Shea, supra at 211

196 *ACT IV GLO,* supra para 91. See to that effect the Case C376/03 *D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen* [2005] ECR I-05821, para 61.

did not because the dividend was exempt in the UK.[197] Accordingly, the CJEU, following AG Geelhoed's Opinion, held that there is no comparability between two non-residents benefiting from the same DTT. As a result, such UK rules and the LoB clause did not constitute discrimination or restriction and hence, they were compatible with the freedom of establishment and the free movement of capital. Consequently, the UK can differentiate between different DTCs with separate MSs.

As a result, even though both Dutch resident companies are subject to the same Dutch tax, they can still be differentiated in a UK-Netherlands DTC by a LoB clause making the payment of a tax credit on dividends conditional on the Dutch resident company satisfying some ownership tests.[198] In fact, the Court emphasized that the grant of a tax credit under a DTC is 'an integral part' of the specific DTC which contributes to the overall balance of the treaty.[199] This also applies to DTC provisions

> … which make the grant of such a tax credit subject to the condition that the non-resident company is not owned, directly or indirectly, by a company resident in a Member State or a non-member country with which the United Kingdom has concluded a DTC which does not provide for such a tax credit.[200]

On the basis of the **ACT IV GLO** litigation, one can conclude that LoB clauses containing a "residence" requirement can be compatible with EU law. It is important to note that there is no mention of "nationality" in this LoB article but only refers to "residence". As Dr. Tom O'Shea indicates, "residents" of the Netherlands can also mean EU "nationals" from any other EU MS who are still residents of the Netherlands,[201] and thus, the fact that there is no nationality clause allows all Dutch residents (who may also be nationals of other EU MSs) to qualify for equal treatment in the Netherlands when they are in a similar situation.[202] This could not happen with regards to a "nationality" condition situation.

The analysis of the LoB article involved in *ACT IV GLO* can be contrasted with an examination of the LoB article comprising nationality clauses applicable under the *"Open Skies"* jurisprudence.

197 ibid 210

198 Tom O'Shea, *'Limitation on Benefit (LoB) Clauses and the EU Part I'* (2008) International Tax Report 5

199 *ACT IV GLO,* supra para 88

200 *ACT IV GLO,* supra para 89

201 O'Shea, supra (n.205) at 6

202 Tom O'Shea, 'Limitation on Benefit (LoB) Clauses and the EU (Part II)' (2008) International Tax Report 2

8. Reconciling *"Open Skies"* with *ACT IV GLO*

The conclusion that can be elicited from the examination of these apparently different judgements is clear in that all LoB clauses are not worded in the same way and thus, each type of LoB clause warrants separate analysis. As a result, it is a matter of determining the type of LoB clause at issue to be able to ensure that each type of LoB clause is properly analysed in view of the EU fundamental freedoms.[203] The difference between the LoB clause approved by the Court in *ACT IV GLO* and the LoB clause rejected by the same Court in *"Open Skies"*, *Factortame and Dutch Ship Registration* is that whereas the former included a "residency" clause, the latter cases contained a "nationality" clause.

According to the CJEU, those clauses involving a "nationality" condition may be incompatible with EU law because they conflict with the national treatment principle as they do not guarantee equal treatment to nationals of other MSs. On the other hand, the Court stated that clauses involving a "residency" condition may be compatible with EU law.[204] Otherwise, such residency requirements can be compatible with EU law after analysing whether such residency condition constitutes an objective justification for breaching a fundamental freedom as can be seen in the *Dutch Ship Registration* case. Therefore, all "residency" requirements are not the same and should be investigated on their own facts.

9. Conclusion

The LoB clause is a significant feature of the DTC network as it is an effective anti-treaty shopping measure to limit treaty benefits solely to legitimate residents. Consequently, it is essential for EU MSs' DTTs with non-MSs to fully comply with EU law since the latter has supremacy over their national legislation and thus also the international agreements concluded by each MS.

Over the last few decades the globalization of trade and investment and the exponential growth in bilateral tax treaties have greatly increased opportunities for taxpayers to engage in abusive treaty shopping that is neither intended nor contemplated by the contracting states.[205]

Globalization forced states to conclude as many DTTs as possible as this serves as an advertisement to attract foreign business and investment to their economy. The

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203 ibid 6

204 This is the reason why the Court did not mention its *"Open Skies"* judgments in *ACT IV GLO*.

205 David G. Duff, 'Responses to Treaty Shopping: A Comparative Evaluation' in Michael Lang and others (eds), *Tax Treaties: Building Bridges between Law and Economics* (IBFD 2010) 102

great number of existing DTTs worldwide removes some of the incentive for treaty shopping at a fairly rudimentary level. Nevertheless, the possibility of treaty abuse still persists and this can be due to the incomplete coverage of the tax treaty network because it is impossible for a country to negotiate with all the countries of the world.[206] Moreover, even where DTTs are in place, there can still be sufficient variations between them for taxpayers to engage in treaty shopping to obtain the most beneficial treatment in international transactions.[207]

It is clear that:

> [t]he use of treaty-shopping as one of the most significant, although not the only international tax planning instrument, demonstrates that in international taxation, the shortest distance between two points is not always a straight line, since the triangulation phenomena can be turned into a significant tax savings mechanism for international companies and economic operators.[208]

In 1987, the OECD emphasized that treaty shopping is undesirable as it frustrated not only the spirit of the treaty but also the provisions of the same.[209] In fact, treaty shopping disrupts the balance in the allocation of taxing rights between the two Contracting States of a DTT, which is a primary objective of tax treaties. Furthermore, it alters the balance of sacrifices and concessions attained between the two Contracting States with the negotiation of a DTT, undermines incentives for third countries to enter into tax treaties if their residents have the option of taking advantage of existing DTTs which other states have concluded and facilitates international tax avoidance and evasion.[210] Moreover, the principle of reciprocity which is at the basis of a bilateral DTT is breached.[211]

From a EIM perspective, as a response to the CJEU judgments examined in Part 3 with regards to the extent of the compatibility of the LoB clause with EU law, one cannot deduce that the Court has a negative inclination towards treaty shopping just because it concluded that LoB clauses containing "nationality" conditions are in conflict with EU fundamental freedoms. This is due to the fact that the CJEU did not attack the concept of treaty shopping as such but it only assessed one anti-treaty-shopping policy.

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206 Richard J. Vann, 'International Aspects of Income Tax' in Victor Thuronyi (ed), *Tax Law Design and Drafting*, vol 2 (International Monetary Fund 1998)

207 Schwarz, supra at 177

208 Vega Borrego, supra at vii-viii

209 OECD Report, *Double Taxation Conventions and the Use of Base and Conduit Companies* adopted by OECD Committee on Fiscal Affairs (1987)

210 David G. Duff, supra at 102

211 This means that when a third country resident "shops" into a treaty, then the treaty concessions are extended to a resident, whose State has not participated in this arrangement and may not reciprocate corresponding benefits (e.g. exchange of information).

A possible solution for the US to solve this problem of compatibility of LoB clauses with EU law is for the US to negotiate a multilateral tax treaty with the EU as a whole instead of inserting LoB clauses in individual DTCs with EU MSs. In this way, this multilateral treaty would apply to all EU MSs in the same way, hence removing any possibility of discrimination that can arise from bilateral tax treaties negotiated by individual MSs with the US. A multilateral tax treaty would reduce the complexity of relations and introduce greater legal certainty since it would replace MSs DTCs and bring uniformity. Indeed, a multilateral tax treaty would remove the need for LoB clauses and other anti-treaty-shopping provisions because if all non-residents were treated the same way, then there would be no need to treaty shop.[212]

As already indicated in the Introduction to this article, the new US-Malta DTC is one of a series of DTTs renegotiated by the US to counter treaty shopping since the previous US-Malta DTT did not contain such a LoB article. With the new DTT coming into effect on 1st January 2011, one hopes that this article will achieve its aim in curtailing treaty shopping and protecting this treaty from improper use by third country residents.

212 ibid 237