

## The relationships between EC law and international tax law – New perspectives

In order to address the relationships between EC law and international tax law, it is necessary to analyse the place and the importance of Member States' obligations deriving from the EC legal order (Part I). This “traditional” approach remains complex. It is indeed difficult to focalise only on tax treaty law and to leave aside MS domestic international tax law, as they are interacting with each other. It is also difficult to identify and define the obligations that the MS should take into account, especially their contents and limits. Indeed EC law, which is a casuistic and praetorian law, evolves constantly.

In this perspective, our approach has been to organise the elements of EC law that MS should take into account. First, it was necessary to demonstrate the binding force of EC law on tax treaty law (Title I) through the analysis of the hierarchy of norms (Chapter 1) and the repartition and the exercise of fiscal competence (Chapter II). Second, we have tried to identify the obligations that the Member states are deriving from the EC Treaty (Title 2) that is to say the prohibition of restriction to the fundamental freedoms (Chapter 1) and the prohibition of State aid (Chapter 2).

This traditional approach has, however, its own limits, as it does not take into account the new relationships between those two norms (Part II). Those two norms are according to us in a reciprocal influence relationship (Title I). EC tax law has been built on international tax law and as such has necessarily been influenced by the latter (Chapter I). The expression of this influence lies in similarities of principles, concepts and terms used. In this context, we are submitting that a new trend may well be coming, the influence of EC law on international tax law. Indeed, despite their similarities, the principles, concepts and terms used in both norms are not identical. Their interpretation by the ECJ may well influence the one of National Courts in their interpretation of international tax law (Chapter II).

The perspectives of evolution of this relationship (Title II) will necessarily depend on the instrument of EC law that may be adopted in the future (Chapter I). The practical suggestions, we have proposed, are not necessarily looking at the best suitable solutions for an Internal

market but are more looking at developing EC compatible tax principles to be applied to cross-border taxation within the EU (Chapter II).

## **First Part: EC law, a source of treaty law obligations**

This first part describes the traditional approach where we analyse the grounds of the MS obligations deriving from the EC treaty and then try to identify and clearly states what those obligations are.

### **Title 1: The binding force of EC law**

The binding force of EC law is the result of the hierarchy of norms, which, in tax matters, must take into account the peculiar nature of DTT (refers to as their “particularism”), and of the repartition of the tax competence between the EC and the MS and their exercise by the EC.

### **Chapter 1: A clear hierarchical relationship, but an atypical one**

In this chapter, we are analysing the general principle of the hierarchy of norms as it results from EC law, but we are also emphasizing that international law principles would lead to the same results.

After having laid down those principles, we are specifically addressing the situation of tax treaty law. It then appears that the principle of hierarchy of norms is of little help in order to address our problematic. Indeed in order for the hierarchy of norms to apply, one need first to identify a conflict between those two norms, and in practice, there are very few ones.

#### Section 1 The superiority of EC law over treaty law

Before addressing this issue, it must be pointed out that in some MS the primacy of EC law over treaty law may not be accepted. The example of France is relevant, as the French Administrative Supreme Court has never accepted to rule that EC law would supersede another treaty, because article 55 of the French Constitution does not establish any hierarchy

between international treaties. Thus, we have analysed the solution to such a conflict, in EC law and in international law.

We have also distinguished the solution to this conflict depending on the situation at stake, that is to say we have distinguished between treaties concluded between MS and treaties concluded between MS and third countries (without distinguishing between the different kinds of third countries that may be identified).

### *I The superiority of EC law over tax treaty between MS*

#### *A. EC grounds to the superiority of EC law*

- The primary ground: the specificity of EC law

The specificity of EC law is a well-known principle developed by the ECJ in its *Costa and van Gend & Loos* cases where the Court has ruled that internal legislation cannot be opposed to the EEC Treaty.

The same reasoning can be applied concerning treaty law, and the ECJ has already ruled in tax matters that DTT, being part of national law, cannot infringe EC law.

- The complementary grounds

An *a contrario* interpretation of article 307 (1), and an interpretation of article 10 b of the EC Treaty would also lead to the same result, i.e. they would ensure the primacy of EC law.

#### *B. The superiority of EC law based on the Vienna Convention*

The Vienna Convention may not be applicable in all Member States. Again, France is a relevant example, as it has never ratified this convention and the Conseil d'Etat has never ruled explicitly on its binding force.

The ECJ refuses to apply its principle within an intra-EU situation, but refers to it in the relationships between MS and third countries or in the EC own international relations.

We believe the application of the Vienna Convention would lead to the same results than the one developed above. When the tax convention would be anterior to the EC Treaty, article 30§3 states that the “old” treaty is applicable only to the extent that its provisions are compatible with the new one. If it is posterior, one would refer to article 41 of the Vienna Convention which concerns the modification of a multilateral convention. It states that such a modification is possible if it not explicitly prohibited and if the modification does not concern a provision to which it cannot be derogated without implying an incompatibility with the effective realisation of the object and of the goal of the whole treaty. Taking into account that EC law must be applied in a uniform manner within the EU, it excludes that two or few MS could derogate to the EC treaty.

## II The primacy of EC law over treaty between a MS and a third country

### A. *Convention anterior...*

- ... to the EC Treaty

Article 307 (1) of the EC treaty preserve their validity to the extent necessary to preserve the rights of the third country contractor, but not the rights of the MS. Therefore, a MS cannot invoke a right that it derives from a treaty with a third States if its exercise would contravene its EC law obligations. However, it must observe the obligations directly deriving from such a treaty.

We submit that article 30 of the Vienna Convention would also lead to such a result.

It is worth emphasizing that the anterior or posterior character of the treaty does not play any role if the rights of the MS are not concerned (the Saint Gobain case is a good illustration of this principle in tax matters).

If article 307(1) preserves the validity of the convention, article 307 (2) of the EC Treaty requires MS to eliminate their incompatibilities. The question of whether or not this

obligation should be fulfilled within a reasonable time frame has been addressed by the doctrine and we submit that:

- the starting point of such a delay is complex (should it be the exact issue dealt with the ECJ that should have been ruled? Or a similar one? Taking into account that a reasoning by analogy is always difficult and uncertain);
  - based on the use of the “present” in article 307 (2) and also in article 10 (1), we consider that the theory of a reasonable delay is justified but we submit that if MS should start diligences as soon as a conflict is discovered, the reasonable delay to solve it should depend on the actual facts and circumstances, e.g. is it a settled policy from the third country to include the litigious provision in its treaty?...
  - if, after a mutual support, the MS do not succeed in renegotiated a tax treaty, they should terminate it as the ECJ has requested in non tax cases; this also justifies the theory according to which article 307 (2) contains an obligation of results;
  - as article 307 does not have direct effect, it belongs to the Commission, in a quasi-discretionary power, to appreciate the delay.
- ... to the *lex specialis*: article 57 (1)

If one admits that tax treaty law is part of domestic law, then restrictions contains within a DTT between a MS and a third country, prior to the date set forth in article 57 (1) of the EC Treaty, are deemed compatible with EC law. This provision has been analysed by the ECJ in the FII case and two elements should be emphasized:

- first, article 57 (1) concerns the restrictions to direct investments, i.e., according to the Court, participations in a company with the objective to create a durable economic link or that gives the possibility to participate to the management or the control of this company. In this case, there would be no incompatible restriction. However, it must be pointed out that, at least for the direct investment linked to the management and control, according to settle case law, the freedom of establishment would be applicable, then article 57 (1) would not be applicable. As a result, in case of a direct investment the restriction would never be incompatible with EC law whatever the date it has been enacted...

- second, an “existing restriction” is a restriction that existed at the date set in article 57 (1), even where it has been confirmed in a posterior law or if its restriction has been mitigated (in a more favourable way for the taxpayer) after this date. It is worth pointing out that the solution here differs from the appreciation of the anterior or posterior character of a convention *vis à vis* the EC Treaty.

This specific provision of EC law has an impact on the compatibility of DTT concluded between a MS and a third country, however it is worth granting that this solution is the result of the scope *ratione temporis* of the free movement of capital rather than the consequence of the hierarchy of norms.

#### *B. The primacy of EC law over posterior treaty*

The primacy of EC law should be admitted based on an *a contrario* interpretation of article 307 of the EC Treaty. The ECJ requires two conditions for article 307 to apply: the rights of the third countries should be at stake and the treaty must be anterior to the EC Treaty.

One point that should be specifically addressed is the possibility for third country nationals to invoke the free movement of capital in tax matters. The ECJ has admitted in the *Sanz de Lera* case that article 56 granted rights to third country nationals. One may wonder if international law principle would not give arguments to consider that when a DTT containing a restriction has been agreed upon by a third State, their nationals cannot invoke anymore article 56. Indeed, according to article 34 of the Vienna Convention, a treaty does not create obligation or rights to third country to a treaty without its consent, the latter being presumed unless some indications show the contrary. One may therefore argue that the conclusion of a DTT containing a restriction is a contrary indication from the third State. This argument has, as far as we know, never been tested.

Finally, the Court has given the definition of what is a posterior restriction. According to the ECJ, the confirmation of an existing restriction in a new tax treaty (posterior to the EC Treaty) leads to consider the restriction as a posterior one.

## Section II. The consequences of the particularism of tax convention

In order for the hierarchy of norms to apply, one should first identify a conflict between the norms, which concerning DTT would be anecdotic. Indeed DTT have a peculiar nature (I) which leads us to distinguish between autonomous, shared and formal incompatibilities (II).

### *I. The particularism of DTT*

Based on the French example of application of DTT, which is used as an illustrative example of a more general - and accepted - principle, our starting point is that DTT, generally, cannot create a tax liability.

Indeed, DTT are allocating the taxing power between the contractors, which then have the right, or not, to exercise this power. The expression of such a principle may vary amongst the different States, it can be based, *inter alia*, on the following principle:

- the principle of “non-aggravation” (principle that is not according to us recognized – yet - under French tax law);
- the French principle of “subsidiarity” of DTT, meaning that in order to apply a DTT one must first refer to domestic tax law in order to demonstrate that French law provides for a ground of taxation and, if this is the case, one would then refer to DTT to see whether or not it limits France right to tax;
- the principle of preservation of the advantages granted by domestic law;
- or a general principle that DTT can limit but not create a tax burden, in other words the exercise of the taxation power must find a ground in domestic tax law.

It is worth mentioning that the ECJ, by making the distinction between the allocation of taxing power and the exercise of the said power, seems to recognize such a principle.

One would, however, reserve the specific case of article 23 of the OECD Model on the avoidance of double taxation that prescribes an obligation to the residence State and that may oblige to follow a specific method to relieve a resident from double taxation, eventually irrespective of the method provided for in domestic tax law.

If a tax treaty cannot create a tax burden, may a double tax treaty may infringe EC law?

## *II. A necessary distinction between different categories of incompatibility*

We will distinguish between autonomous, shared and formal incompatibility. This distinction does not imply a direct application of the hierarchy of norms theory, though it is used in order to state that in the case of a shared incompatibility, the fact that the provision is justified or provided for in the DTT does not in itself relieve it from its incompatibility. Because EC law is superior to DTT, the mere fact that a restriction lies in a tax treaty has no impact on its validity.

### *A. Shared incompatibility*

A shared incompatibility is an incompatibility of a provision of a DTT with EC law that would arise when the latter provision is only the vehicle of the incompatibility, i.e. the incompatibility would have its source in a MS domestic tax law and the DTT would either not eliminate completely the incompatibility or would refer to a domestic mechanism that would be incompatible.

This kind of incompatibility can be illustrated by the Bouanich and Denkavit case. In the latter case, for example, the ECJ had to rule whether or not the withholding tax rate of 5% on dividends paid to a non resident by a French company, when a resident company would if some conditions would be fulfilled, be exempt on those dividends is a restriction to the freedom of establishment.

The ECJ, first look at the domestic provision allowing France to levy the withholding tax and points out that there is a difference of treatment of a comparable situation that is not justified and is therefore incompatible with EC law.

The Court then looked at the impact of the DTT. It provides for a limited source taxation of the dividends and for a tax credit mechanism to avoid the juridical double taxation. However, as the Netherlands were exempting the dividends it did not grant any tax credit. The Court then stated that the combination of the DTT and Dutch domestic tax law did not allow the neutralisation of the French restriction.

In this case, one would have to admit that the tax treaty provision is not in itself incompatible with EC law, the ECJ refers to the DTT solely in order to check whether the latter eliminates the restriction that is arising directly from French domestic law. If it mitigates such a restriction (the 5% treaty rate being lower than the 25% domestic rate), it does not eliminate it.

The Conseil d'Etat, seems to have applied this reasoning as, in its ruling, it decided that it is the domestic provision that is incompatible with EC law.

We submit that because taxation must find a ground in domestic tax law, a tax treaty provision will rarely be itself incompatible with EC law, the restriction taking its source within domestic law.

#### *B. Autonomous incompatibility*

An autonomous incompatibility would be an incompatibility of a tax treaty provision that would have its source within the treaty itself.

We have identified two kind of incompatibility:

- with regards to the freedoms: there would be an autonomous incompatibility when the treaty would provide for a distinction that would contravene EC law. The best example is the Saint Gobain case where the exclusion of permanent establishment from the scope of the treaty leads to a non-justified difference of treatment between resident and non-resident. It is worth mentioning that this distinction may also exist in domestic law, or can be solved on the ground of domestic law, it remains however that the difference of treatment of a comparable situation is provided for by the tax treaty itself. In such a case, the ECJ requires the extension of the tax treaty benefits. Concerning article 23 of the OECD Model tax convention, as it provides for an obligation, it would lead to an autonomous incompatibility if the method prescribed in the tax treaty would infringe EC law.
- with regards to State aid: because it is the aim of double tax treaty to provide for tax advantages for the taxpayer compared to a situation where treaties would not be applicable and where only domestic tax law would apply, one would consider, if EC

law prohibits such advantage on the ground of article 87 of the EC Treaty, that the source of the incompatibility is in the tax treaty.

### *C. Formal incompatibility*

A formal incompatibility would be an incompatibility that would arise due to the fact that a provision of a tax treaty would provide for a difference of treatment that would be incompatible with EC law if it would apply, but which is not applicable, for instance, because the domestic law would not provide for the necessary grounds for taxation.

According to the Court, the mere fact that it may confuse the taxpayer as to the right it derives from EC law may constitute an incompatibility.

This last category would have little impact but would, however, engender the formal penetration of EC law into DTT provisions. For instance, article 10 of the OECD Model should then refer explicitly to the exemption of withholding tax in case the conditions of the directives would be met.

It is possible to establish a connection between the theory of autonomous and shared incompatibilities and the ECJ settled principle according to which Member States are at liberty to define the connecting factor to allocate their power of taxation but should then exercise those powers in an EC compatible manner. A shared incompatibility would arise when the exercise of the power is not compatible with EC law and an autonomous one would arise when the ECJ would provide for some limits on the free allocation of taxing power. Again, it must be stressed that if the limitation of the taxing power provides for a prohibited State aid this would lead to an autonomous incompatibility, i.e. the free allocation of power of taxation, as allowed by the ECJ in the freedoms' domain, may well raise issues on the ground of article 87.

Our distinction between autonomous and shared incompatibility is important in the framework of our analysis of the relationships between EC law and tax treaty and has led us to broaden the scope of our analysis to international tax law (i.e. tax treaty and domestic international tax law). It has also an impact on the solution of harmonisation we are submitting, indeed, if one harmonizes treaty provisions, this may well lead to avoid autonomous incompatibility, but what about shared one?

## **Chapter II. The Allocation and exercise of tax competence**

### Section I Tax harmonisation within the EU

#### I. The true tax harmonisation: the directive

##### *A. The ground of the competence*

- The Traditional ground

The traditional ground for the competence of the EC is article 94 of the EC Treaty, which provides for a competence to harmonize legislation to the extent necessary to realize Internal market.

It cannot be considered as an exclusive competence and should be viewed as a shared one. More precisely, MS, which are the first owner of this competence, may decide to share it with the Community.

Acting through article 94 of the EC Treaty implies to respect the obligation set by its article 5, i.e. the subsidiarity and proportionality principles. As a result, the action of the Community should be necessary and MS should not be able reach the same result. Guidelines to apply those principles are stated in Protocol 7 to the Amsterdam Treaty.

- Other possible grounds

Article 96 of the EC Treaty may well be a ground to harmonize tax legislation though at least from a political point of view, this possibility may not be realistic. Moreover, taking into account that the competence does not belong to the EC, any harmonization based on such a provision would also be subject to the principle of article 5 of the EC Treaty, meaning that directives adopted on this ground would probably be criticized before the Court.

Article 95 § 1 could have been a ground to adopt legislation not directly related to tax but for example to the fight against tax fraud etc... However, the example of the directive on mutual

assistance in the recovery of claims shows that the Council and the ECJ are reluctant to grant such interpretation to this provision.

If one accepts that despite an explicit competence, it is accepted that harmonisation may be grounded on article 94, one may wonder if it would not be possible to adopt such legislation based on other provisions of the EC treaty that are aiming at removing restrictions such as article 44 or article 52. One would also wonder if article 12 could not be used?

### *B. Consequence of harmonisation*

- A residual competence of the MS

Whatever the ground for harmonisation would be, this will be done through a directive. However, the harmonisation leaves rooms for MS in the implementation of the objective of the directive. This actually is harmful to the uniform application of EC law. It seems that the institutions have noticed this and are trying more and more to define with more details the content of the directives. This to some extent, may be interpreted as going against the subsidiarity principle that requires that Community measures have to leave as much as possible decision power to the MS.

Beside the necessary consequence of such freedom that may lead MS to misinterpret directive at the time of their implementation, the use of the directive as an harmonisation tool have impacts on the application of DTT.

The place of DTT in those harmonized sphere is quite important. First of all, a particular place is granted to DTT by the directive themselves. Obviously, this does not mean that DTT are superior to EC law, as the same principle than the one developed in the first chapter justifies that directive is superior, in the hierarchy of norms, to DTT.

Consequently, in case a DTT infringes EC secondary legislation, this may result in an infringement proceeding or in a court decision based on the hierarchy of norms.

However, the case of the infringement of directive by a DTT would be rare. Indeed, a directive usually provides for a minimum advantage that the MS would be at liberty to extend or to go further.

Moreover, due to their particularism, DTT also grants advantages to the taxpayer. Taxation must be grounded on a domestic provision. In case of an infringement of EC law this would in most of the cases be based on domestic tax legislation that would not have implemented (or wrongly implemented) a directive.

In other words, directives usually do not have impact on treaty law but rather on domestic international provisions. It is true, however, that as directives are rarely implemented in DTT, this may lead to formal incompatibilities.

Directives are usually considered as providing for minimum advantages. We submit that such interpretation should be debated. Directives provide for advantages in order to realize a goal. Therefore, the incompetence of MS or the incompatibility of domestic / DTT provisions would occur if they do not target the same goal. Usually, granting more favourable advantages or the same advantages under less restrictive conditions will target the same goal, i.e. this will benefit to the internal market. However, we believe this is not always the case.

An obvious case would be the Savings directive, where, for the States that have the right to withhold taxes instead of exchanging information, one would agree that a DTT cannot provide for a lower withholding tax than the one provided for in the treaty.

We believe that in some cases, this is not correct; sometimes the objective of the directive may well lead to consider that advantages cannot be extended. For example, the interest and royalty directive that provides for the credit method to avoid double taxation in cases where withholding taxes are levied would forbid MS to grant a tax sparing credit (based on article 6 and 9 of the directive).

In the same perspective, can a MS exempt from withholding tax interest and royalty if the revenue is not effectively taxed in the MS of residence of the recipient? We believe that the recital of the directive that provides that the revenue should be taxed once would lead to consider that this cannot be the case. The interpretation of the directive in the light of the

freedom of establishment but also in the light of state aids provision would support this position.

## II Elimination of double taxation

### *A. Article 293: the nature of the instrument*

For some reasons<sup>1</sup>, we argue that the instrument provided for in article 293 is not an EC instrument but an international one.

However, this does not mean this instrument does not have a special nature. The latter would find its ground in international law principles and more precisely in article 41 of the Vienna Convention. As a consequence, MS would not be able to derogate unilaterally or bilaterally to such a convention as the fact that those conventions are “linked” to EC law prohibit them to derogate from it, otherwise there would be an incompatibility with the effective realisation of the goal and object of the instrument.

### *B. The competence to eliminate double taxation*

Once we consider that article 293 provides for the exercise of the MS competence, it is difficult to consider that this provision would grant a subsidiary competence to the MS where the Community would be at first competent, and this despite any specific provision provided for this competence that would therefore be based on general provision of the Treaty and therefore subject to article 5 and the subsidiarity principle.

As a consequence one would admit that article 293 reaffirms the competence of the MS in this matters and provides them with a multilateral instrument to reach this goal, even where one may consider, correctly, that article 293 may very well be considered as making double use together with article 5.

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<sup>1</sup> I.e., the fact that those instruments are excluded from the *acquis communautaire*, that the ECJ is incompetent to interpret them, on the comparison between instrument of article 308 (and the interpretation of the Court in case 38-69) and the one of 293, and finally to the ECJ decision that considers that those instruments are “linked” to the EC Treaty (e.g. case C-398/92).

Far from establishing the competence of the EC, we believe that this provision may very well prevent the EC to harmonize tax law, even if experience has shown, so far, that this is not a relevant argument.

If article 94 provides for a ground for the EC to exercise its competence, it should be pointed out that article 293 makes it more difficult to justify that the subsidiarity principle is not infringed when the EC issues a directive. One of the key element to justify that the objective is better achieved through a directive is its multilateral character. However, article 293 also provides for a multilateral instrument. Consequently, the sole advantage of article 94 over 293 would then be its interpretation by the ECJ, which can also be achieved contractually.

Therefore, as the main reason to adopt the interest and royalty directive was the elimination of double taxation, one may wonder if the adoption of the directive complies with article 5, even where one may consider that the Council found necessary to adopt a “common tax regime”, which, at least formally, may only be achieved through a directive.

## Section II: The external competence of the EC

### *I. The theory of the implicit external power of the Community*

The theory of the implicit external competence of the ECJ has evolved and has been clarified by the ECJ through the years. One would distinguish between the competences based on:

- The AETR doctrine

The AETR doctrine that implies that the Community has exercised its internal competence and has either determine the situation of third countries or of its nationals, or the competence to negotiate with third countries has been included in internal legislation. Finally, the competence is recognized if the harmonisation of the domain is complete in the internal order (as in this case the internal legislation would be altered by international agreement concluded by MS with third States).

- The Avis 1/76 doctrine

The Avis 1/76 implies that the international agreement is adopted at the same time than the internal harmonisation measure and that this agreement is necessary

## II The external competence in tax matters

### *A. In theory: an incompetence of the EC*

Based on the current directives in tax matters one would conclude that the EC is incompetent, whether on the ground of the AETR doctrine or on the Avis 1/76 one.

One may also use the allocation of competence in order to interpret directive. For instance, if one argues that PE of EU resident companies located in a third State should benefit from DTT, the allocation of competence would prevent this interpretation.

### *B. An empirical competence: the EU Switzerland agreement*

We have difficulties to determine the ground of the competence allowing the EU to contract with Switzerland. In any case, it seems that the EC has exceeded its competence, and that such agreement should have been concluded in a mix act, i.e. an act signed by the EC and the MS.

More precisely, it seems to us that by adopting measures equivalent to the parent subsidiary and interest and royalty directives in the international agreement, the EC has exceeded its power. Indeed, according to the Court, the competence based on the AETR doctrine, is exclusive in the sphere covered by those acts. Based on the Avis 1/76 doctrine the international agreement is adopted at the same time than the internal measure.

One would also stress that according to the Court the competence should then be exclusive. However, it seems that MS are concluding DTT with Switzerland and sometimes grant more favourable treatment to Swiss companies than the one provided for in the Agreement. We believe they do not have anymore the competence to do so. The international agreement is different from a directive where in some cases it is up to MS to extend the benefit of the directive and grant more favourable treatment. As mentioned before, this is possible if it pursues the aim of the directive, i.e. the Internal market, which is not possible in the case of the agreement. Finally, if the agreement preserves the past regulation (internal and bilateral), the same is not true for the future regulation.

## **Title II: The Obligations deriving from EC primary law.**

In this part are analysed the two prohibitions arising from EC law, the one of restrictions to the freedoms and the one of State aid.

### **Chapter 1 The prohibition of restrictions**

Despite of some tentative to classify the different kinds of restriction, the doctrine did not succeed in defining precisely the different categories of restrictions. This is mainly due to change of politics of the ECJ and to the fact that it seems to have decided to apply the different freedoms in the same manner even where, literally, they are different.

We have built our own theory in order to try to define precisely those different restrictions. However, we must admit that all cases do not fit into this theory.

#### Section I The prohibition of incompatible restrictions

##### *I The different categories of restriction*

We submit that there are three kinds of restrictions:

- Discriminatory restriction

Article 12 prohibits discrimination. However, according to settled case law this prohibition is implemented through the different freedoms. Therefore, we submit that each freedom defines what is a discrimination and sets its characteristics.

According to us, there would be a discrimination if there is a difference of treatment of a comparable situation that would be based on the nationality (or residence for the indirect one) of the person who literally benefits from a right, the latter being violated by the MS that infringes the obligation stated in the applicable freedom. *A contrario*, if the violation is the fact of a MS that does not have express and literal obligations or if the restriction affects a person that is not literally protected under the applicable provision there will be no discrimination. This would not mean that the restriction is compatible with EC law but it has to be eliminated on another ground.

- The true non-discriminatory restrictions

The true non-discriminatory restrictions arise from a rule that is applicable without distinctions when the rule impedes the effective use of a freedom or is disadvantageous because it does not take into account the element of extraterritoriality.

This category finds its origin in the *Cassis de Dijon* case that has been nuanced in the *Keck* and *Mithouard* cases. Under current status of the case law, a rule that would apply without distinction would infringe EC law if it conditions the access to the market, i.e. when it impedes a person to access the national market. The *BAA* case and the *Bosman* one, are examples of such a doctrine.

- Other non-discriminatory restrictions

This category is defined *a contrario vis à vis* discriminatory ones. This is a restriction arising from a rule that would differentiate comparable situations but that would not be discriminatory either because the MS infringing EC law is not the one which has an obligation under the provision of the EC Treaty applied, or because the person affected by the restriction is not the one protected by the said provision. One of the key elements of this category is that it implies a teleological interpretation of the EC Treaty.

## II The justifications of the restrictions

Once a restriction is proved, one would have to look whether or not it can be justified.

We point out that the comparability of the situation is either a characteristic of the discrimination or a possible justification of the other categories of restriction.

With regards to justifications, we have emphasized the coherence of the tax system and the “winning combination” of the fight against abuse together with the preservation of allocation of taxing power between MS.

It is worth pointing out that the evolution of the justification’s sphere is important and is the proof of the protection by the ECJ of MS interests.

### Section II Analysis of the restrictions to the freedoms

#### I. Freedom of establishment and freedom to provide services

##### *A. Freedom of establishment*

- The qualification of the restriction depends on its author

In our view, a literal interpretation of the Treaty would lead to consider that there is discrimination when the infraction is the fact of the Host MS (Avoir fiscal, Royal Bank of Scotland...). There would be a non-discriminatory restriction if the author is the origin State (Daily Mail, ICI...).

It should be pointed out however that in the recent case law the ECJ does not seem to make this distinction anymore, for example in FII (where the Court applies the discriminatory doctrine instead of the non-discriminatory one, though the author is the origin MS) and Columbus.

The Columbus case is also relevant as it seems that the Court necessarily rejects the theory of true non discriminatory restrictions, and to do so rely on the principle of equality of treatment. This is not a new justification as it had been used in the Sandoz case referring, more precisely, on the principle of equality before tax to reach the same result.

- Status and obligations of the MS of establishment

The question debated here is whether the MS of establishment should be considered as being the host or the origin State? Once a company is established, how acts the MS of establishment?

We must admit that we have not find a final solution, as the ECJ case law is not clear on this point and seems to allow both interpretation.

#### *B. The freedom to provide services*

It must first be observed that the scope of this freedom is limited to the EU resident. The Scorpio case has made clear that the service recipient and the service provider should be located within the EU and the services should be performed within the EU.

- Discriminatory restrictions

There is a discriminatory restriction when the service provider is restricted to perform the services in the MS in which it is not established, and when it suffers directly from the restriction.

- The “rebound” restriction

It is often the case in tax matters that the recipient of the services supports the tax consequences of the restriction to the freedom to provide services. In the later case, the ECJ sometimes look at the impact of the measure on the service provider to consider that there is a restriction. We believe that those kinds of restriction are non-discriminatory as the person directly suffering the consequences of the restriction is the service recipient.

## II. Freedom of movement of capital

### *A. Between MS*

Our distinction between the three kinds of restrictions is not relevant in this case. The literal interpretation of this freedom leads us to consider that it prohibits the restrictions to the movement of capital themselves, and therefore that a discrimination may be the fact of the MS exporting or importing the capital and whoever is directly affected by the measure.

It is worth pointing out that this theory has some consequences. For example, the Kerckaert case - where the Court decided that there was no discrimination because there was no difference of treatment - is a consequence of the application of the discriminatory theory. Indeed, in the case of the freedom of establishment, this would have been an origin state restriction, i.e. non-discriminatory, and one should have analysed if the taxpayer was discouraged to invest in foreign companies. We believe that it would have been the case. However, as pointed out earlier, the ECJ in the FII case (i.e. an origin State situation) has ruled on the ground of the discrimination theory to judge that the exemption and credit method was an equivalent treatment. On the ground of the non-discriminatory doctrine, the same result may not have been reached. One may even think that the ECJ uses this “trick” to find (inappropriate) grounds to base its (political or subjective) decision.

By considering that there is no disadvantage or that the situation is not comparable, the Court by the application of the discriminatory doctrine avoids to declare the restriction and to rule on the justification and on the proportionality test.

### *B. Freedom of movement of capital between MS and third State*

- The OECD influence

First, we have underlined the similarities between the OECD Code of Liberalisation of movements of capital and the EC free movement of capital provisions.

This leads us to recognize that what could be viewed as a unilateral liberalisation from the EC is “only” a way to give a binding force to the commitment endorsed in this Code. It also

shows that it was probably the will of the MS to leave tax matters outside the scope of this freedom.

In any case, we consider that granting the same force to the free movement of capital in a non-EC context would not have been appropriate, especially, one would not be allowed to apply a teleological interpretation.

- The limitation of the effect of the free movement of capital

The ECJ has followed such a line of reasoning and has reduced the power of this freedom.

First by interpreting the free movement of capital in the light of its discriminatory doctrine (i.e. non-discriminatory restriction, requiring a teleological interpretation, would not be prohibited).

Second, it has developed a doctrine to restrict the scope *ratione materiae* of this freedom, by considering that if two freedoms are applicable, one would only look at the freedom which is primarily affected. As the freedom of services or of establishment, are not applicable to extra-EU situation, there would be no restriction at all, and this even where the free movement of capital is impacted secondarily.

Third, it has implicitly suggested to the MS to argue that the situations are not comparable, or to try other justifications that would probably be combined with a less restrictive application of the proportionality test.

## **Conclusion**

This Chapter has been used to study in details the reasoning of the ECJ in tax matters that we have tried to rationalize. Even where we have been unable to find a reading plan where all case would fit, this exercise has been useful and has allowed us, *inter alia*, to acknowledge the following:

- we have been able to distinguish between teleological interpretation and the discriminatory doctrine;

- we came to the conclusion that the Court is trying to give the same interpretation to the freedom of establishment and to the free movement of capital, as the drop of the distinction between the discriminatory and non discriminatory doctrine in the last case law tend to show;
- we came to the conclusion that the ECJ by applying the discriminatory doctrine finds a mean to preserve the sovereignty of the MS.

We believe that the lack of clear guidelines in the ECJ case law is detrimental to the taxpayer and to the MS as it creates uncertainties. The current situation is not appropriate.

We are convinced that nowadays the Court is, before all, judging subjectively, i.e. based on what it believes to be necessary under the current status of the internal market and bearing in mind the interest of MS. In other words it seems to look for fair decisions. It is difficult – if not impossible – to predict how the ECJ will rule a case, and the sphere of justification and proportionality – which entails a quasi-discretionary power - would convince those who believe they can do so.

The Truck centre case is quite illustrative, as we believe that the way of reasoning of the Court was unpredictable based on previous case such as Scorpio, Tupeinen, Commission v. France... If we use to be in favour of the compatibility of the withholding tax mechanism, inasmuch as it implies a timing difference, we were considering that it was a proportionate restriction.

The consequence of those uncertainties is that the number of case would increase in the future because we are convinced that the national judges are not able, under the current evolution of the case law - under the current confusion -, to correctly apply EC law.

However, the current situation is not only the consequence of the ECJ but is also due to the MS that have refused to harmonize EC law and to give guidelines that the ECJ would follow as they would reflect the current status and needs of the Internal market.

## Chapter II The prohibition of State aid

We believe that State aid prohibition is an underestimated issue. This is partly due to the difficulty - under the current status of the evolution of this sphere of EC law - to understand what is prohibited or not by this legislation.

One of our task has been to ascertain whether or not it may have an impact on tax treaty having in mind that domestic international tax law is with no doubt subject to this obligation.

### Section I. Tax treaty advantages in the light of State aids criteria

#### I. A selective advantage

- Advantages of tax treaty

It is the very nature of DTT to grant tax advantages to the taxpayer compared with the unilateral application of domestic international tax law by both the source and residence States.

We have pointed out numerous examples of advantages in the Commission's decision practice that are similar to tax treaty advantages (in the source and residence States). One may refer to the examples of the exemption of withholding tax ("precompte mobilier") in the Belgian coordination centre case (hereafter BCC case), or to the switch from the credit method to the exemption method to avoid economic double taxation of dividends or of PE profits in the Irish case.

- The selectivity of the advantage

We have compared decision of the Commission concerning the selectivity of some domestic State aids in order to reach the conclusion that tax treaty may well be considered as being selective.

Under state aid law, a selective advantage is an advantage granted to certain type of enterprise or production. This is with no doubt one the most difficult criterion to interpret. However, one will note that a tax treaty is by nature selective. It applies to companies having an international activity, to recipients that are resident of a contracting State, to recipients that are beneficial owner of the income...

Even if one may doubt of the selectivity of DTT on those grounds, e.g. because one may consider that companies have to be in the same circumstances in order to assess whether or not a company benefits of a State aid, it is worth pointing out that the mere exclusion of PE from the scope of DTT may raise issues. A PE and a resident company, which are usually in comparable situations (in the freedom sphere of EC law), are not subject to the same treatment, the resident company being able to benefit from the tax treaty advantages.

Finally, the degree of selectivity may depends on the provisions of the DTT that are aiming at preventing treaty shopping (LOB type of provisions) and that require numerous conditions to be met.

- The beneficiary of the state aids and its author

There are potentially two beneficiaries of the advantages granted by a tax treaty:

- the direct one would be the one that receives a relief provided for in the tax treaty;
- the indirect beneficiary would be the contractor of the direct beneficiary. For instance, due to the decrease of the withholding tax rate, the contractor would be able to purchase a service at a lower price. The practices of gross-up clause (underlined in the OECD commentaries), is supporting that the service provider is usually taking into account the taxes that it may suffer in the source State. It is worth pointing out that in the BCC case the Commission has considered that the aid was granted to the BCC entity but also to groups to which it belongs.

This is not only a theoretical issue, as we consider that State aids rule may very well be applicable in a situation involving a MS and a third State, the resident of a Member State contracting with the direct beneficiary of the advantage may well be considered as receiving an aid.

The other issue is to determine which State is granting the advantage (bearing in mind that DTT are reciprocal). In a treaty context, this may lead to consider that the responsibility would be shared even where it would be advisable to determine a hierarchy of the responsibility.

- The impact on competition

This criterion will always be met under the current status of the law, which only requires the Commission to demonstrate that the aid can have an impact on competition. The simple fact that the advantages benefit to some companies *vis a vis* its competitor allows to consider that competition has been affected.

Our conclusion is that the State aid issue deserves a particular attention, as, at first sight, treaty benefits are liable to fall within the scope of this legislation. We have then entered into a more detailed analysis.

## Section II A temporary impunity of DTT

### *I The ground for a case by case preservation of treaty provision*

#### *A. The difference between the general tax regime and a regime justified by the nature of the system*

- The position of the Commission

Though the Commission has never issued a detailed analysis on tax treaty and state aid, it seems to consider that tax treaties are a general system.

This is based on the 1998 Communication of the Commission that excludes implicitly tax treaty, and on its decision practice. In the BCC case, the Commission has stated that the procedure does not aim at levying a withholding tax on all transactions, as it does not target the exemption granted by the general system, i.e. the exemption granted by Belgian law, EC law or DTT.

This position seems difficult to sustain and may appear illogical when the Commission considers that tax-sparing credits granted by DTT are prima facie State aid. Beside, even where one would consider that DTT forms a general system, the PE exclusion seems, in itself, to exclude that this general system is compatible.

We believe that the correct interpretation would be to consider that it is justified by the nature of the system.

- Specific measures justified by the nature of the system

This exception is actually the fifth characteristic of State aid and finds its origin in the ECJ case law. It is extremely difficult to define its exact meaning under the current status of the law. According to the Tribunal of first instance, this justification refers to the coherence of a specific measure with the internal logic of the tax system in general. We believe that this is the case of tax treaty provisions in the sphere of international tax law.

Justifying DTT via this argument engender some consequences. For instance, each measure should be appreciated on a case-by-case basis and, as it is an exception to a general rule, it should be interpreted strictly.

#### *B. A case by case analysis of treaty provision*

We are of the opinion that one should make a distinction between the provisions that are inherent to DTT and the others.

- Inherent provisions of double tax treaty

The internal logic of treaty law within the global system of international tax law should be able to justify the consequence of the allocation of taxing power, i.e. withholding tax rate concession and the granting of tax credit or even the exemption method of dividends or PE profits.

Again, a doubt arises from the issue of the exclusion of PE from the scope of tax treaties.

- Other tax advantages

One may distinguish specific and true advantages:

- Specific advantages

In some cases, tax treaties grant benefits to taxpayers based on some criteria, e.g. a reduction of withholding taxes on dividends depends on the amount of money invested in a foreign company, or a withholding tax exemption of interest depends on the use of the principal amount or of the quality of the lender (e.g. no withholding tax for banks but withholding tax for others)...

The adoption of specific criteria to determine the existence of PE depending on their domain of activities may also be criticised, so as the use of different methods to determine the taxable results of a PE depending on its activities...

Those advantages may very well be considered as being State aid, as they would probably not be justified by the nature of the system.

- True treaty advantages

Advantages such as tax sparing credits but also, probably, the UK ACT mechanism that was reimbursed to the non resident shareholder provided the tax treaty expressly granted this advantage are probably raising State aid issues.

Another advantage that is more important as it relates to a more fundamental question is whether or not a tax treaty that would provide for a double non-taxation would be justified by the nature of the system. It is the very nature of DTT to provide for double taxation relief, but if the resident company is not taxed should the source country grant a withholding tax relief? This relief is an advantage that is justified by the fact that the revenue is subject to another Member State jurisdiction, and therefore the advantage would be neutralised by the taxation in the residence country (the neutralisation effect is recognised under the freedom sphere).

If there is no taxation, the nature of the system does not necessarily allow the advantage to apply. As a result, the concept of residence defines under article 4 of the OECD Model may have to be interpreted, in the light of State aid law, as meaning that a resident company should be effectively subject to tax.

## II. Qualification of State aids: distinction and consequences

In this part, we are analysing the definition of existing State aid versus new State aid. A new State aid that would not be notified to the Commission would be considered as an illegal State aid and, as such, its beneficiaries should reimburse.

An exception to the recuperation of the aid is the case where it can be argue that the taxpayer could not know that the advantage was a State aid. We believe that the doubt raised and the position of the Commission that we have underlined together with its own contradiction, would lead to consider that the recuperation would not be able to occur in a first stage. In other words, the taxpayers may rely on the legitimate expectation argument.

## **Second part: The new relationships between EC law and international tax law**

The atypical hierarchy between tax treaty and EC law implies the analysis of domestic international tax legislation. We have considered it from a conceptual point of view, i.e. without taking into account the specificities of each national legislation. This approach allows showing that some concepts, common to the MS, may lead to some restrictions. The uniformisation of national legislation is actually one of the aims of EC secondary legislation (to the extent that it tends to reach a goal set by the EC Treaty). Harmonizing concepts, which, to a certain extent, are already converging, seems to be, a priori, doable. One of the main issues is that EC law may well turn upside down some international tax law concepts that we have tried, based on a pragmatic approach, to preserve. Beside, we have tried to limit harmonization effects to intra-EU situation, which is not so easy taking into account that according to us if international tax law influences EC law, the latter also influences the former leading to a reciprocal influence between those norms. In this environment, the perspectives of evolution of EC law are uncertain, but we have tried to solve the main issues via the adoption of a pragmatic approach.

### **Title I The theory of the reciprocal influence of EC law and international tax law**

#### **Chapter 1: The influence of international tax law on EC law**

This influence can be seen in all domains of EC law, that is to say on the application of the freedoms, on secondary legislation, on State aids and on the EU Code of conduct and on its application.

##### Section I The influence of international tax law on the applications of the freedoms

This influence is revealed by the ECJ when it states that: *“It is settled case-law that in the absence of unifying or harmonising measures adopted in the Community the Member States remain competent to determine the criteria for taxation of income and capital with a view to eliminating double taxation by means, inter alia, of international agreements. In that context,*

*the Member States are at liberty, in the framework of bilateral agreements, to determine the connecting factors for the purposes of allocating powers of taxation.*

*However, as far as the exercise of the power of taxation so allocated is concerned, the Member States must comply with the Community rules (see, to that effect, Saint-Gobain, cited above, paragraph 58) 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.”*

### I. The free allocation of powers of taxation

- A progressive adoption of this principle

It starts with the acknowledgment by the ECJ of the freedom to choose the criteria to allocate powers of taxation between MS, such as duration of an activity, nationality, or residence.

The liberty of allocation has been consecrated by the ECJ when it rejected the MFN principle, by recognizing that the application of a DTT is limited to persons mentioned into it, that two non-residents (one entering in a DTT and the other into another one) cannot be compared, as the limitation of their scope is inherent to DTT.

According to us, and as the debate around both MFN and LOB issues supports, the solution was depending on the place the ECJ wanted to grant to DTT. Its position, especially concerning the MFN, is politically tainted, as the Court is itself suggesting in its judgement.

- A total liberty?

The ECJ seems, in the ACT case, to have legitimated “Limitation of benefit” type of provision. This is a specificity of the tax area compared to other domain of EC law. Indeed, if one compares this case law with the Open sky case, it appears that the reasoning of the Court diverges and is due to the importance of DTT and then to the influence of treaty law over EC law.

We believe however that some issues have not yet been solved and that many uncertainties remain, e.g.:

- in the ACT case the treaty did not create any restriction, but this was due to the fact that UK domestic law was not itself restrictive. If a treaty excludes a person from its scope and leaves the place to a domestic restriction, there would be a shared incompatibility. We then debate on the best way to repair this restriction, either in extending treaty benefits to the excluded person or to focus on the sole domestic provision. The latter solution would probably be adopted as we submit that the extension of tax treaty benefits is reserved to autonomous incompatibility case.
- is the fact that the treaty was concluded with a MS that is obliged under EC law not to apply shared restriction important? In a treaty with a third State (acting as a source State), the sole mean to protect EC taxpayers is to oblige MS not to insert LOB... Indeed, the third state has no obligation to set aside restrictions. The doubt created by this question is supported by the fact that, if we transpose it to tax matters, this was the situation in Open Sky...
- in ACT situation, can we consider that the residence State by concluding this tax treaty has failed to obtain an equal treatment? Is the difference of treatment - that is based solely on the ground of residence of its resident companies shareholders - an infringement of EC law from the residence State point of view?

The access of PE to treaties, which should be granted from the point of view of the state of *situs* of the PE, is a connected debate, i.e. should the source State of an income paid to a PE be at liberty not to grant treaty benefit to the PE? We believe that the exclusion of PE should be considered as an autonomous incompatibility also from the source State point of view, this should lead to extend the benefit of the tax treaty to PEs (the autonomy of PE principle supports this view). However, an alternative reasoning would be to oblige the PE State to neutralize the restriction by granting to the PE a tax credit equivalent to the withholding tax levied.

We are in favour of the first solution that would be based on the bilateral responsibility of the autonomous incompatibility arising from the exclusion of the PE from treaty benefit.

## II The exercise of the taxing power

- The limit of the influence

The limits of the influence of international tax law are in the effects of EC law on the exercise of MS taxing powers: the effects of the obligations of EC law are the limit of the influence.

This is illustrated by the effect of EC law on the source State in the interpretation of the residence principle that became, since *Denkavit* and *ACT*, a mere criterion that allows determining whether or not a company is subject to tax in the source State. If the source State do not tax a non-resident they would be in a different situation, but if the source State effectively tax it, it should ensure that the non-resident obtain, at least, the benefit of national treatment.

The residence State under current status of evolution of EC law does not derive many obligations from EC law. The sole obligation would be to treat national and foreign income in the same manner (see an exception in the *de Groot* case, where it seems that the residence State may transfer part of its obligations to the Source State) and this even where this would lead to a disadvantage, as the *Kerckaert* case has shown (we point out however that this case, and also *Columbus*, was ruled on the ground of the discriminatory doctrine).

As a result and even where both EC law and treaty law aims at avoiding double taxation, nothing would oblige MS to reach the said goal, under current EC law status the sole obligation would be to apply, at least, the national treatment.

This is surely an unsatisfactory result. One could have imagined that the combination of article 293 and article 10 of the EC Treaty would lead to consider that double taxation would infringe EC law. However, this is not the case and such a solution would have obliged the judge to determine the responsibility of such double taxation, e.g. is there a treaty override? What if there is a conflict of interpretation? It should be stressed that the ECJ refuses to interpret treaties, for instance, if it sometimes refers to the OECD Model this is only if it has been presented as being part of the applicable national law by the national court. Consequently, the prohibition of double taxation would have raised numerous unresolved questions, and complexity.

- The impact of international tax law on restrictions

Even where the limit of its influence lies into the effect of EC law, we point out that international tax law has some effects on the compatibility of the restriction.

Two relevant examples of such incidence of EC law are:

- the neutralisation theory, where a restriction of a MS may be neutralised by the other MS (in this case it belongs to the MS at the origin of the restriction to ensure that it would be effectively neutralized);
- the arm's length principle has been considered as a legitimate restriction (see Thin cap case).

## Section II The influence of international tax law on other sphere of EC law

### I. The influence of international tax law on secondary EC legislation

- The reference to DTT

The directives are making several references to DTT, for instance to define their own scope and to solve potential hierarchy of norms issue.

- Similarities in the terms and concepts

The first wave of directive was quite imprecise, with few definitions of the concepts and terms used. One could note similarities between the OECD Model and the drafting of the directive, e.g. to define what is a “company of a MS” (similar to article 1 and 4§1 of the OECD Model).

The second wave is much more influenced by international tax law and the OECD Model. One would, *inter alia*, note the following examples:

- the terms interest and royalty is similar to article 11 and 12 of the 1992 OECD Model;
- we find similar principle than the one of article 11§6 and 12§4, in the recital and in article 4§2 of the interest and royalty directive;

- the PE definition (in the amended parent subsidiary directive and in the interest and royalty one) is similar to article 5§1 of the OECD Model (one would point out that this definition does not appear in the merger directive that is using more than ten times this concept, we submit that this is due to the incompatibility, in the context of the merger directive, of this concept, so defined, with the freedom of establishment: in this context a “deemed PE” concept should be recognized, i.e. a PE should be recognized even in the absence of a fixed place of business);
- the concept of beneficial owner is defined by the interest and royalty directive, with a different definition for PE and company. This leads us to consider that the taxation in the *situs* or in the residence State is a requirement applicable for both PE and company. Indeed, this is the only reading that ensures that the directives are not treating differently comparable situations (the ECJ considers that if there are two readings possible, one should interpret the directive in the way that ensures its compatibility with EC law). Moreover, this interpretation would be in line with our interpretation of the recital of the directive that states that income should be taxed once, and we believe this interpretation would be in line with State aid legislation.

If some authors consider that this influence of the OECD Model would lead to take into account the OECD Commentaries for interpreting the directives, we believe that this would not be the case. It is worth emphasizing that “supplementary means” of interpretation are not taken into account by the ECJ to interpret directives and that one key rule of interpretation of EC secondary legislation is that they are read in the light of EC primary law.

## *II The influence of international tax law on State aids and on the fight against harmful tax competition*

- The influence on State aids

As mentioned in the analysis of State aid legislation, the position of the Commission that seems to grant a special place to DTT is with no doubt a result of the influence of international tax law. Our own conclusion that grants a special place to DTT is influenced (and justified) by the ECJ case law in the freedoms’ domain, though one would stress that freedoms and state aids are two different spheres of EC law.

The arm's length principle is an example of international tax principles recognised by the Commission in its State aid decisions. It ruled several times that the recognition of a State aid may well be based on the fact that the method to determine the result of a company does not comply with the arm's length principle.

- The influence on the fight against harmful competition

The influence of the OECD is important and one would stress the similarities between the processes that have been implemented in parallel by the OECD and the EU in this domain (even where the scope were a bit different).

The Code of conduct refers to OECD principles and the Primarolo report does refer to some OECD principles or to DTT to identify, *a contrario*, harmful measures.

To this respect, one would quote the Z002 measure - Swiss finance branch of Luxembourg company – (that we submit could still be analysed on the ground of State aid), and the EAM 009 Austrian exemption rule.

## **Chapter II The influence of EC law on ITL**

### Section I A limited influence of EC law on DTT

#### I. Treaty law, the construction of the EU and the freedoms

- The influence of the EU reality and of the freedoms

Based on the analysis of tax treaties and reports of the French Parliament we submit that the EU countries when negotiating treaties are comparing the advantages obtained by the other MS. There is a benchmarking of the advantages. This trend will probably increase due to the Cadbury Schweppes case allowing tax optimisation when substance is implemented (i.e. MS should have the best treatment to avoid treaty shopping).

The development of the treaty network between the MS is also the result of the EU construction, even where MS derive no obligation to act as such.

The EU freedoms have very little formal influence on the drafting of tax treaties. The only example would be the LOB clauses negotiated with the US. It seems that MS tried to reduce the restrictive effect of such provisions. However, this was before the ACT case...

Even if it appears disappointing, one would point out that despite this lack of formal influence, EC law have impact on international tax law. There are numerous reforms implemented by MS to be in line with their EC obligations (CFC rules, withholding tax, thin capitalisation rules...) but due to their particularism, DTT are not directly impacted.

- Toward a greater influence of EC law

Based on the analysis of the ECJ case law we submit the following:

- provision targeting the limitation of the access to treaty will increase (therefore we will propose to coordinate those clause);
- there is a risk that the Commission try to fight against formal incompatibilities;
- the doctrine of neutralisation may lead to a conceptual change in tax treaty application, MS may be willing to ensure that the allocation of taxing power would not only empower MS to tax but would lead to an effective taxation. This allows to neutralize the potential source MS restriction. Moreover, this would, according to us, be more in line with State aid legislation;
- the allocation of taxing power may well be done, more and more, on a case by case basis. For example, one may imagine a debt to equity ratio to apply thin capitalisation that would be included in a treaty provision to ensure that the restriction in one state is neutralized in the other; due to the end of CFC rules, one may imagine that MS will choose to which treaty partner they are willing to grant the exemption regime on dividends and PE profits while applying the credit method for others.

## II The influence of other sphere of EC law on DTT

- The influence of EC secondary legislation

Even where one may find in the treaty network of MS references to all the tax directives, the formal influence is quite limited and is the fact of few MS, which, for some reasons, have this treaty policy.

Beside the particularism of treaty law that explains this limited influence, we believe that the other factors are the following:

- some MS may fear that by implementing the directives into their tax treaties, this may lead to grant the same benefit to third countries due to the MFN clause that they may have concluded with third State;
- MS are probably hesitating to mix treaty and directive provisions as they may fear that the ECJ through the interpretation of EC law would affect the interpretation of treaty law: this would increase the confusion that is already existing due to the similarities of wording. Such interpretation issue is illustrated through the example of the ISDA case.

- The Code of conduct

Based on French Parliament report, it appears that the Code of conduct and its consequences may well be an element of decision when concluding a treaty with another MS (e.g. the French Belgian treaty).

Some MS are sometimes including some reference in their DTT to the Code of conduct principles in order to limit its scope.

It is worth pointing out that State aids legislation has no formal impact on DTT, but the influence of this sphere of law should probably be looked at from a WTO perspective.

## Section II. The influence of EC law on the interpretation of international tax law

### I. The influence of EC law on the non-discrimination principle

Those two principles are shared between EC law and treaty law for a long time and we submit that the EU principles have / can have an impact on the interpretation of the international non-discrimination principle.

According to a leading author, article 24§1 of the OECD Model has been modified to include the words “*in particular with respect to residence*” to avoid that the ECJ case law would influence the national jurisdiction interpretation in a treaty context.

Based on the French Biso case, we show how the two principles may be confused or mixed up. In this case law the Advocate general at the level of the Administrative Court of Appeal is willing to apply the tax treaty and the EC non-discrimination principles in the same way. The Advocate general and to a lesser extent the Conseil d’Etat seems to have been influenced by the ECJ case law but on the principle of combination of two tax treaties dealt with by the ECJ in XAB and YAB .

We submit that the ECJ case law may well, in some cases, e.g. where the commentaries and the treaties are not clear, have a decisive influence on the solution of the national tribunal judging on the ground of the tax treaty provision.

One would also refer to some case law of other MS High Court such as the one of the Federal tax Court in Germany that has applied the Uberseering reasoning in a treaty situation with the US.

### II The theory of the influence of EC law on international tax law

It is difficult to demonstrate this theory, and the doctrine is of little help to this respect. We have identified some arguments based on the Vienna Convention’s principles that would give a legal ground to the use of ECJ case law to interpret tax treaty non discrimination principle, i.e. based:

- on article 31: the EC context would influence the meaning of the terms;

- on article 31§3 of the Vienna Convention, where we would consider that the EC Treaty is a relevant international law to be taken into account in order to interpret a provision of a tax treaty;
- on article 32, where the ECJ judgement would be a supplementary mean of interpretation;
- on article 30§4, where we would consider that it was the intention of the parties to give a special meaning (an EC one) to a term used in a tax treaty provision.

It seems to us, that the evolution of the law, and the diffusion of the EC interpretation of the non-discrimination principle may well become the intention of the parties when MS are concluding treaties with each other.

Even third States may be influenced by EC law, and we found some examples in India and in Switzerland.

If this influence cannot be proved we emphasize that we found some clues in the case law of the French Conseil d'Etat, the Spanish Tribunal Supremo, the Italian Corte di Cassazione, the Dutch Hoge Raad, the Bundesfinanzhof, the Indian Advance ruling commission, and the Swiss Federal appeal commission...

Finally, we believe that the report of the OECD on the application of the non-discrimination principle in a treaty context is a very relevant illustration of our theory. Indeed, the OECD discusses in this paper the influence of the EC concept of non-discrimination and, we believe, try at several occasion in the modification of the OECD Commentaries to article 24 to fight this influence.

In any case, we submit that this influence will be more and more important due to the influence that international tax law had on EC law. All the concepts of international tax law that have become EC law concepts will be influenced by their interpretation by the ECJ. This may be the case for the beneficial owner, the PE concepts, the interest and royalty definitions (e.g. the Polish Supreme Court has referred to the definition of royalty in EC secondary legislation – but not the tax directive – in order to interpret the royalty meaning in a tax treaty context)...

The influence of ECJ case law may also expand through the conclusion of international agreement (e.g., the Swiss tax administration is interpreting the EU-Swiss agreement in the light of the ECJ Denkavit I case law etc.).

Finally, the use of the ECJ as an Arbitrage Court may also lead to “standardize” tax treaty and EC law concepts. If EC law may influence national Courts, the ECJ will most probably be influenced by its own case law and may use (and abuse) article 3(2) of OECD Model in order to refer to EC law principles or to refer to an autonomous meaning of tax treaty terms.

## **Title II Perspectives of evolution of the relationships between EC law and international tax law**

### **Chapter 1: Theoretical perspectives**

In this chapter, we have analysed the different theoretical alternatives to the conflicts between the norms and then set the guidelines of the approach that according to us should be followed.

#### Section I. The solutions proposed by the doctrine

##### *I. The Viennese school*

The Viennese school has proposed a multilateral model of convention, which would solve the main issues arising from the current bilateral network, and that would be based on the OECD Model. This multilateral convention would grant an arbitration power to the ECJ.

According to them, this convention could also take the form of a directive, though a multilateral convention would allow keeping some (bilateral) specificities and also flexibility (e.g. not all MS would be obliged to ratify it in a first stage).

##### *II. The European Model of Professor Pistone*

This Model is atypical as it would provide for a compulsory and binding set of rules, that would derive its legal force from article 293 of the EC Treaty.

Beside compulsory provisions that are the minimum required to ensure the compatibility of DTT with EC law, the Model would leave negotiation rooms to the MS, which would offer them some flexibility. One of the key principles would be to abandon the *lex fori* principle.

We believe that article 293 of the EC treaty may not be appropriate to issue such a convention and that a pure multilateral convention, containing some specific provisions to ensure a special binding force to it, should be preferred, if this option would be chosen.

### *III. A non binding model*

The Commission seems to be interested in a non-binding model of convention.

We believe that those solutions are not appropriate to deal with the problems raised by the relationships between those norms. One of our key objections being that it would lead to perfectly EU proof treaty provisions but that it would be a factice harmonisation. Indeed, as discussed before, most of the incompatibilities deriving from international tax law are contained in MS domestic international tax legislations, the shared incompatibilities would therefore remain.

## Section II. For a new approach

### *I. A pragmatic approach*

- Identification of incompatible restrictions

A pragmatic approach would take into account that bilateral conventions are participating to EU objectives and in practice function quite well. That is in domestic legislation that one has to identify the main restrictions to the freedoms. In other words, one should not harmonise the allocation of taxing powers between MS, which are in most cases EC compatible, but rather the exercise of such a power.

- The choice of the instrument

We believe that all instruments studied by the doctrine have its own merit. All legal grounds such as article 12, 94, 96, 293, or even a pure multilateral convention have its advantages and disadvantages.

The best solution would be to choose between those different instruments the one that is the most appropriate to deal with the issue at stake.

For example, a directive may not be appropriate if it leaves treaty provision unaffected, again the taxpayer would have the choice between those treatments. However, in some case this would be a good option because this would provide them with such a choice. Beside, a directive is, according to us, more legitimate to influence, i.e. to regulate, the application of primary EC law.

On the other hand, a multilateral convention could be appropriate in some cases, as it would allow the amendments of all previous provisions contained in bilateral treaties with MS. One of the key element is also that each MS would be in front of its own responsibility, it would have the choice between concluding it or not, and the MS who are reticent to adopt it would not be able to hide behind the unanimity rule. The Commission could also play an important role by initiating infringement procedures against the incompatible bilateral provisions of the MS that have not concluded the multilateral treaty.

- The resolution of restriction through an influential harmonisation

There are numerous example in the case law that tend to show that there is a fundamental difference between a restriction and a legislation that is harmful to the internal market (Kerckaert, D, FII, ACT, Columbus...). There are also numerous cases that remind us that a restriction is not necessarily incompatible with EC law (Marks and Spencer, Oyo AA, Thin cap...).

Based on this, we submit that the harmonisation process should not necessarily try to reach the best suitable solution for the internal market but to start ensuring that fundamental principles of cross border taxation are compatible with EC law.

The theory of “regulation” is a theory according to which EC secondary legislation influence or at least should be able to influence the implementation by the ECJ of EC primary law. The EC legislator would design the boundaries of EC tax law. It would define what is needed under current status of the internal market and where the EU should go, step by step, to improve its functioning.

We strongly believe that if EC secondary legislation should not infringe EC primary law, the legislator should be able to define the priorities of the EC and influence what restriction is or not justified and proportionate. This role, that the ECJ is currently playing, is not a judge role but should be a political one.

Our proposal is therefore to harmonize tax legislation by removing the most important barriers, not necessarily through the implementation of the best solution required in an achieved internal market and leave some minors restrictions that would be removed gradually.

The regulation theory is not completely proven. We found a similar reasoning in the Advocate General conclusions in some tax cases. We also believe that the FII case is supporting this theory, as the judge would have probably not considered the equivalence of the exemption and credit method in the absence of the parent subsidiary directive. We found also supportive arguments in the Inspire art case law.

This theory may be viewed as a danger for EC law, as if it is not well used, i.e. if the legislator uses it to counter ECJ case law, it would affect EC primary law. But in such a case, we believe that this would undermine the effect of this theory. Again, it is designed to improve the compatibility of MS tax systems by preserving their interests and the one of the EU and of the taxpayers. MS are legitimate in their will to preserve the basis of their tax systems and to switch toward an EC cross-border tax system, compatible with EC law, and which in a second stage would go toward a better functioning of the internal market.

*II A search for equilibrated solution the consequences of which must be predictable*

The MS must find a way to adapt their tax systems to the EC “new deal”. Indeed EC freedoms have granted to the taxpayers a lot of tax optimisation opportunities by removing CFC legislation within the EU, by condemning thin capitalizations rules, by decreasing the relevance of resident and non-resident distinction for the application of withholding taxes...

If one considers that all those tools are inapplicable, then tax optimization is largely open and taxation may well be the exceptions. We have compared the tax strategy to optimize tax situation of companies in an EC context, in an OECD context and have envisaged complex structure mixing the use of freedoms, friendly tax environment within the EC and tax heaven within the world to demonstrate that the situation is not sustainable.

In theory, in the EC, State aid and freedoms should lead to have a fair competition within the internal market. However, some countries are not following the rules and play an individual and selfish game. This undermines the internal market.

As a consequence, we are in favour of a change of policy where the Commission (as it started to do in 2007) would take into account the interest of the MS. We will go toward a necessary removal of restrictions, together with more anti abuse rule and even the statement of the principle of a unique but effective taxation within the EU. The Commission should also review its policy with regards to approval of State aid regimes.

One would also reassess the possibility of edicting some principle of taxation of income going in and out the EU. At least, political pressure should be put on MS that are concluding DTT with tax heaven especially when they do not contain exchange of information provision.

In order for the MS to be more willing to harmonize tax law, we suggest that the interpretation of directives should be more predictable. A comparative analysis of the interpretation method of the ECJ with the Vienna Convention and OECD principles, suggests that some references to preparatory works should be included in the directive.

One should also define clearly the terms and concept used in directives. We are of the opinion that it does not belong to the Court to develop EC tax principles, for example a coherent case law on the interpretation of the PE concept, this is to the legislator to define it. Leaving such a room to interpretation creates too much uncertainty for MS.

In order to anticipate on the influence of international tax law on EC law and vice versa, we are of the opinion that one should adopt EC own tax concepts that would be based on international concepts but that would be appropriate to the EC specific situation. In order to keep those concepts EC ones, we suggest to grant them EC denominations and EC definitions.

## **Chapter II The practical perspectives**

In this chapter, we are analysing the most important restrictions that should be dealt with by the EC and the MS in order to be in line with their EC obligations. We have not dealt with extra-EU situation that should, in most cases, be considered as compatible with EC law, as it was shown through our developments. Obviously, a directive - that would be carefully drafted to avoid a transfer of competence - would support, via the regulation theory, our findings.

### Section I. For a reform of taxation of cross-border flows of income

#### I. A reform of withholding tax motivated by the ECJ case law

The mechanism of withholding tax appears to infringe EC law whether one would look at it from a taxable base, a tax rate or from an effective tax rate point of view:

- from a taxable base point of view: Centro Equestre and Conijn case law show that the taxation of gross revenue applicable to non-residents where residents are taxed on a net basis is a restriction to EC law. However, those case law emphasize the possibility not to apply the exact same tax base: MS may implement a different tax base definition based on the principle of the “direct economic link” developed by the ECJ;
- Gerritse and Denkvit case law show that the application of a higher tax rate to non resident than to resident is a restriction to EC law;
- Bouanich case law shows that one may compare effective tax rate to demonstrate that there is a restriction to EC law, though this may deserve a confirmation from the

Court, this method seems to us the most suitable to demonstrate a true restriction (indeed, in *Centro Equestre* we believe that the restriction was not necessarily proved).

Based on the ECJ case law, such restrictions may be neutralized by the residence MS, but the source MS, which are at the origin of the restriction, must make sure that it is effectively neutralized, through the effective imputation of the tax credit. It seems that the Source MS should even check whether the beneficiary of the income is in a taxable position in order to offset its tax credit (based on *Kerckaert* case, it seems that the residence country does not derive from EC law the obligation to provide for the carry forward of tax credit).

The identification of a restriction has to be proved on a case-by-case basis, and we believe that this is not a satisfactory solution from a tax policy point of view, as too many factors should be taken into account.

We therefore proposed the implementation of the national treatment principle in all MS for source taxation.

## *II The national treatment principle*

This method is conceptually simple, each MS would apply to the non-resident the same tax treatment than to its resident, with the exception of the “direct economic link” that would be defined in more details in the instrument chosen to harmonize / coordinate MS domestic law. We believe that this reform should be performed through a directive, as it goes further than to avoid double taxation. Moreover, the use of a directive would allow MS to continue to provide for different treatment in a DTT, the taxpayer being able to choose whatever suits him the best, though State aid legislation would require that the revenue is effectively taxed (in the source or residence State).

We have proposed to insert anti-abuse provisions:

- the arm’s length principle would be recognized;
- an anti-conduit rule would be inserted in both the directive and DTT (drafted in our developments);
- a beneficial owner clause would be provided for (drafted in our developments);

- if the company is a pure letter box, we submit that EC freedoms should not be applicable and that the MS would be in a position to apply restrictive measures.

Obviously, PE would benefit from this directive. We have also proposed to include them in the scope of existing DTT through a multilateral convention that would amend automatically all the treaties in force between MS.

The consultation phase would be very important because even if it is conceptually simple the national treatment proposal will, in its implementation phase, reveals many practical issues, some of them being analysed in our developments. We are aware that the implementation of such principle would be burdensome and that it goes against the current trend of withholding tax exemption within the EU. However, we believe that with 27 MS, we will not reach a complete exemption of withholding tax in the near future, especially taking into account the recent trend over the world that sees the source taxation principle reinforced. Beside, we believe that the exemption method is not a fair method. Indeed, it leads to double exemption and it does not lead to a fair allocation of resources and, at the end, is disadvantageous for the poorest MS.

## Section II Toward a reform of the PE concepts and of its taxation principles

### *I. Toward a modification of the concept of PE*

We believe that the PE concept raises some issues in the light of EC law. Two freedoms may be applicable, the freedom to provide services and the freedom of establishment, and depends, *inter alia*, on the duration of the activity.

However, the duration criteria set in the OECD Model differs from the one applicable to determine which freedoms apply.

Based on the ECJ case law, requiring a company to register or to set up a PE (though not in tax cases), in order to provide some services for a short time frame (having in mind that a 1 year activity and even more through a fixed place has been considered as falling into the scope of the freedom to provide services) is the negation of the freedom to provide services.

As a consequence, it is possible that the PE concept would infringe EC law when the freedom to provide services would, due to the fact and circumstances of the situation, be applicable.

Though the difference is thin, one should consider that the restriction would not be the criteria of allocation of the competence but rather the consequences that having a PE imply, in terms, *inter alia*, of obligations.

The demonstration made in our development shows that the concept of PE is at risk. Even where we believe in the current trend of case law that the Court may not want to censure this very important concept of international tax law, we believe the risk worth to be addressed and should be analysed and dealt with in a directive that would define the EC law meaning of PE. It could then be introduced in all MS treaties (with other MS) via the use of a multilateral convention. In order to restrict its implication to intra-EU situation (i.e. to avoid as much as possible an influence over international tax law) a special EU denomination should be chosen.

## II. Towards a modification of the taxation principles of PE

- Towards the recognition of the fiscal autonomy of PE

Based on the ECJ case law, we believe that in the *situs* state, a PE should be treated as a separate fiscal entity. This autonomy would be in line with the ECJ case law (especially since the Lidl case) but also with the trend followed by the OECD (even though it would require going further).

Again, this would require a consultation phase to deal with all practical issues that would arise from the implementation of this principle.

- Cross border loss relief

We believe that it is an unavoidable solution. For instance, denying interest deduction in one State depending on the form of the secondary establishment (i.e. PE or subsidiary) should not according to us be justified, even where there would be some arguments to sustain that in the residence State there is no taxation of the said “interest” leading to a neutralization of the disadvantage.

In the State of residence of the company having a PE in the *situs* state, we were already of the opinion, based on the AMID case and the Marks and Spencer one, that the MS should not be obliged to allow the deduction of the PE losses. We believe that the Commission paper on cross-border loss relief is the illustrative example of the necessity of making a distinction between what is required by EC law and what would be good or necessary in the internal market.

Having said that, we submit, based on ACT, Ritter Coulais and Rewe, that the obligation to grant loss relief at the time the losses are incurred by the PE is the consequence of the combination of EC law and the imputation method by the residence state (we consider that MS can choose between the exemption method and the credit method to relief those entities from double taxation (based on FII)).

## **Conclusion**

In our conclusion, we have summarized our main findings and the methods and the solution advocated to harmonize EC law.

We have also addressed the consequences of the Treaty of Lisbon in case the latter would be accepted. It appears that the latter would introduce and remove several provisions that may have an impact on EC tax law, *inter alia*:

- it opens the possibility to make step backs in the harmonisation process as it allows to repeal directives, such a “des-harmonisation” process would undermine EC law;
- the doubt that we have raised on the fulfilment of the obligations set in article 5 of the EC treaty with respects to article 293 would fortunately disappear together with the latter provision (this may have been be an argument to des-harmonised EC law)
- another step back that would be allowed by this Treaty is the possibility to legitimate, under article 65 of the Treaty (corresponding to article 58 of the current EC Treaty), restrictions to the free movement of capital with third countries. This opened the door to a hard version of the theory of regulation that we have developed;
- it simplifies the use of intensified cooperation.