DIVIDEND TAXATION AND THE LOB CLAUSE IN THE US-SWEDEN DTC

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1 Introduction

Most double tax conventions (DTCs) contain anti-abuse provisions. Limitation of Benefits clauses (LoB) are one example. These clauses are regularly found in DTCs with the USA. They include various tests that have to be satisfied by a taxpayer who wishes to enjoy benefits under the convention. The function of a LoB clause is to limit the personal scope of a DTC. The USA has LoB clauses in various forms in most of its DTCs with EU Member States (MS).

It has been argued that these clauses are incompatible with EC Law in restricting the freedom of establishment or free movement of capital. The Commission states that such provisions, limiting some of the treaty benefits to companies resident in one of the contracting states, excluding resident companies if they are controlled by foreign shareholders, are contrary to Community law.[1] The Commission refers to the *Saint-Gobain* case[2] and the *Open Skies* cases[3]. In the opinion of the Commission, such

1 In "*EC law and tax treaties*", 9 June 2005, Ref.: TAXUD E1/FR DOC (05) 2306, a working paper, at p.12

2 Case C-307/97 *Compagnie de Saint-Gobain SA, Zweigniederlassung Deutschland v Finanzamt Aachen- Innenstadt* [1999] ECR I-6161.

3 Case C-466/98 *Commission of the European Communities v United Kingdom of Great Britain and Northern Ireland* [2002] ECR I-9427; Case C-467/98 *Commission of the European Communities v Kingdom of Denmark* [2002] ECR I-9519; Case C-468/98 *Commission of the European Communities v the Kingdom of Sweden* [2002] ECR I-9575; Case C-469/98 *Commission of the European Communities v the Republic of Finland* [2002] ECR I-9627; Case C-471/98 *Commission of the European Communities v the Kingdom of Belgium* [2002] ECR I-9681; Case C-472/98 *Commission of the European Communities v Grand Duchy of Luxembourg* [2002] ECR I-9741; Case C-475/98 *Commission of the European Communities v the Republic of Austria* [2002] ECR I-9797; Case C-476/98 *Commission of the European Communities v Federal Republic of Germany* [2002] ECR I-9855.

provisions may not only be in breach of the freedom of establishment,[4] but also Art. 10 of the Treaty establishing the European Communities (ECT)[5]. The question is therefore whether the mere entering into a DTC amounts to a hindrance of the freedoms?[6] The Ruding Report stated that treaty provisions such as LoB clauses "can discriminate against enterprises of other Community countries".[7] [8]

The case law of the ECJ at present seems to point in a certain direction with regard to capital movements. That is, a capital movement between a non-MS and a MS does not necessarily have to be treated in the same way as a capital movement within the EU.[9] Hence, home state and source state obligations in the context of dividend taxation, cannot be applied to non-EU MS situations without some precaution.

1.1 DTCs and EC law[10]

The abolition of double taxation is an objective of Community law, enshrined in the EC Treaty in Art. 293. ECJ has held that Art. 293 does not have direct effect, however it obliges Member States to enter into negotiations with each other so far as is necessary with the objective to abolish double taxation within the Community.[11]

4 Through the exercise of taxing powers.

5 Through allocating powers to tax.

6 An issue raised in the *Open Skies* case law was that of the loyalty obligation in Art. 10 ECT. It was held that 'all reasonable steps taken (by Belgium) to eliminate the incompatibility' was not sufficient (Case C-471/98 *Commission v Belgium* [2002] ECR I-9681, para. 143) to justify the breach. It thus seems like an argument that the MS has taken all reasonable steps in the negotiation procedure to commend the other contracting state to agree an EC compatible provision would fail if the provision in practice were discriminatory.

7 Commission of the European Communities (Ed.), Report of the Committee of Independent Experts on Company Taxation – *Ruding Report* (1992) p. 206.

8 For the equal treatment principle of the ECT with respect to LoB clauses see " *An Internal Market Without Company Tax Obstacles – Achievements, Ongoing Initiatives and Remaining Challenges*," COM(2003)726 final, 11.

9 It is also possible that the involvement of a third state creates a difference in circumstance as regards the search for a proper comparator. See P. Pistone, "*The impact of European law on the relations with third countries in the field of direct taxation*", Intertax 2006 Vol. 34, Issue 5, p. 237.

10 On this topic see Hansson, L. "*The Compatibility of Limitation on Benefits provisions in Tax Treaties with EC Law – a special focus on the new LoB provision in the income tax treaty between the United States and Sweden."* Unpublished. www.jur.lu.se/library

11 Case C-336/96 *Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, paras 24-30.

The origin of the difficulties in this area result from the fact that on the one hand Member States have retained their sovereignty in direct tax matters. On the other hand, inherent in the EC Treaty and as a general principle of supremacy of Community law, Member States nonetheless must exercise their competence in conformity with Community law. The competence retained by the MS in this field includes the right to enter into bilateral tax treaties for the avoidance of double taxation. This allocation of taxing powers is not incompatible with the ECT, even if the criterion chosen as connecting factor is nationality.[12] Difference in treatment of nationals from two contracting states that results from the connecting factors for allocating taxation rights cannot constitute discrimination contrary to Art. 43.[13] The same reasoning applies to Art. 56 ECT. In *van Hilten*[14], the Court held that regarding difference in treatment on the basis of domestic legislation between residents who are nationals of the MS in question and those who are nationals of other MS, such distinctions cannot be regarded as constituting discrimination prohibited by Art. 56 ECT, since their purpose is allocating powers of taxation.

It is settled case law that Community law does not contain a principle of Most Favoured Nation treatment. Following the *D* case[15] it is clear that a MS can have a more favourable DTC with one MS than with other MS without having to extend those benefits since certain non-residents are not in the same situation as residents.

1.2 Anti treaty abuse provisions

Anti treaty abuse provisions are included in a DTC to avoid "Treaty Shopping". Treaty shopping is however not considered abusive by the ECJ.[16] The mere

12 *Gilly*, para. 30.

13 See Case C-376/03 *D v Inspecteur van de Belastingdienst* [2005] ECR I-5821, paras 50-52 and Opinion of Attorney General (AG) Geelhoed delivered on 23 February 2006 in Case C-374/04 the *Class IV of the ACT Group Litigation*.

14 Case C-513/03 *Heirs of van Hilten- van der Heijden v Inspecteur van de Belastingdienst/Particulieren /Ondernemingen buitenland te Heerlen* [2006] ECR I-0000, para. 47.

15 See footnote 13. The court held that "the fact that those reciprocal rights and obligations apply only to persons resident in one of the two Contracting Member States is an inherent consequence of bilateral double taxation conventions" (para. 61). The Court referred to the situation in *Saint-Gobain* to exemplify the situation in which benefits under a DTC may extend to a resident of a MS that is not a party to the convention. At the same time the Court states that *D.* is different from that case since it involves the comparison of two non-residents (paras 55-58).

16 Leaving the distinction between tax evasion (unlawful), tax avoidance (lawful but harmful) and tax planning (lawful and harmless) aside (see P. Merks, "*Tax evasion, tax avoidance and tax planning*", Intertax 2006, Vol. 34 Iss. 5 p.281), the ECJ in *Lasteyrie du Saillant* used the terms tax evasion, tax avoidance and tax fraud interchangeably. Case C-9/02 *Lasteyrie du Saillant v Ministére de l'Économie* [2004] ECR I-2409.

structuring of investments in such a way as to benefit from the least restrictive tax laws is a legitimate exercise of the freedoms and does not amount to tax avoidance.[17]

A bilateral treaty without anti-abuse provisions would easily become a treaty with the world; the benefits in a treaty between two states are not intended to be extended to non-contracting (third) states. The USA is determined to prevent treaty shopping and hence includes extensive LoB clauses in its treaties.[18] The concern is that taxpayers investing in the USA seek out the treaty that provides for the lowest rate of taxation on investment income generated in the US. 'What the US test does, in essence, is to identify a connection between a company's taxable base and the tax system of a state (together with a local shareholding requirement) as one facet of residence that is significant enough to justify entitlement to the benefit of the treaties concluded by that state'.[19]

Even though the OECD Model Tax Convention on Income and Capital (the OECD Model) does not contain a LoB clause, the OECD recommends its members to negotiate LoB clauses and the Commentary contains an example of a LoB clause.[20]

2. The Sweden – USA DTC

Sweden signed a new Protocol[21] with the USA in 2005 amending the existing DTC[22]. The amendments introduce a zero-rate withholding tax (WHT) on dividends from certain subsidiaries.[23] The Protocol also introduced the new LoB clause[24] to

17 See for example *Centros*, Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459 and *Eurowings*, Case C-294/97 *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna* [1999] ECR I-7447, *Barbier*, Case C-364/01 Heirs of H. *Barbier v Inspecteur van de Belastingdienst Particulieren/Ondernemingen buitenland* [2003] ECR I-15013, *Cadbury Schweppes* Case C-196/04 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue [*2006] ECR I-7995 and *Thin Cap*, Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* Celex No. 604C0524.

18 Whether these clauses are effective or not to obtain this purpose, is another question.

19 Joanna Wheeler, *'The Attribution of Income to a Person for Tax Treaty Purposes'*. IBFD Bulletin November 2005, at p. 484.

20 OECD Commentary from 2003 on Art. 1, paras 19-20.

21 'Lag (2005:1088) om ändring i Lag (1994:1617) om dubbelbeskattningsavtal mellan Sverige och Amerikas Förenta Stater'. The change entered into force by 'Förordning (2006:1080) om ikraftträdande av lagen (2005:1088) om dubbelbeskattningasavtal mellan Sverige och Amerikas Förenta Stater' on 30 September 2006.

22 'Lag 1994:1617 om dubbelbeskattningsavtal mellan Sverige och Amerikas Förenta Stater'.

23 This is the third US treaty to eliminate source tax on qualifying inter-company dividends. It already exists in the treaties with United Kingdom and the Netherlands.

replace the previous Art. 17[25] of the DTC. According to the Technical explanation[26], the negotiations took into account the US Department of the Treasury's current tax treaty policies and the US Department of the Treasury's Model Income Tax Convention of 1996 (the US Model). In addition, the OECD Model was also taken into account.

2.1 The qualification tests

2.1.1 Publicly Traded Company test

A resident[27] company of a contracting state shall be entitled to all the benefits of the convention if the resident is a company whose principal class of shares is regularly traded on one or more recognised Stock Exchanges.[28] In addition, the company must meet either a primary place of trading test or a primary place of management and control test. A company is also entitled to benefits if the company is a subsidiary of publicly traded companies and certain conditions are met.

The reasoning behind the publicly traded company test is that these companies are rarely used for treaty shopping or abuse purposes. The new provision extends the number of accepted stock exchanges from only the NASDAQ-system and Stockholm Stock Exchange to stock exchanges in the EU, EEA, Switzerland and NAFTA.

The publicly traded company test might risk infringing the freedom to provide (or receive) services since it involves a requirement that the company in question is traded on one or more recognised stock exchange. If the stock exchanges recognised exclude a stock exchange of the Community it would put this in a less favourable position than those recognised. The ownership requirements under the indirect stock exchange test may infringe on the freedoms under Arts 43 and 48 ECT. Furthermore, LoB clauses that do not include every EU stock exchange for purposes of the direct stock exchange test may independently infringe on the freedom to provide services under article 49 ECT or on the freedom of capital movements under Art. 56 ECT.[29]

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24 Art. V of the Protocol.

25 Begränsning av förmåner; Limitation on benefits.

26 United States Department of Treasury Technical explanation of the Protocol signed at Washington on September 30 2005.

27 As defined by Art. 4 of the DTC.

28 Subparagraph 2 (c) of the new LoB clause.

29 Kofler, *European Taxation Under an 'Open Sky': LoB clauses in Tax Treaties Between the U.S. and EU Member States*, Tax Notes Int'l, July 5, 2004 p. 51.

2.2.2 Ownership/base erosion test

Subparagraph 2 (e) of the new LoB clause provides a possibility for a resident legal entity to be qualified to receive treaty benefits if it meets two tests:

1 It is predominantly owned by certain qualified residents of the contracting states that are themselves entitled to treaty benefits under certain parts of paragraph 2 (ownership test) and,

2 It is not making substantial[30] base eroding (e.g. deductible) payments to persons not residents of either contracting state (base erosion test).

DTC benefits could be enjoyed indirectly by obligees (lenders, insurers, licensors) of the company. If these persons are residents of a third state, this is supposedly circumvented by the base erosion test. This clause is of particular interest to the question of the compatibility of LoB clauses with Community law.

2.2.3 Derivative benefits test

To qualify under this provision the company must meet an ownership and base erosion test.[31] The ownership test essentially says that seven or fewer so-called 'equivalent beneficiaries' must own shares representing 95% of the value and the voting power of the company.[32] The effect is that a person can claim benefits under the DTC if he could have claimed these benefits had he received the income directly. Hence, derivative benefits can be extended to third state residents and, if they pass the test, this also shows that obtaining tax benefits did not motivate the chosen structure.

As mentioned, the USA-Sweden DTC provides for a zero-rate WHT on dividends arising in the US. Derivative benefits would be extended only to third state residents who also have this zero-rate in their treaty with the US. This means that a Swedish subsidiary owned by a holding company in any EU Member State other than the UK and the Netherlands,[33] would not qualify for the zero-rate on dividends arising in the US.

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30 Substantial in this context is more than 50% of the gross income for that fiscal year.

31 Para. 3 of the new LoB clause.

32 The definition of equivalent beneficiary is set out in paragraph 7(g). Essentially, it means a resident of any EU, EEA, NAFTA country or Switzerland, if that resident would be entitled to all the benefits of a DTC between the country of source and the country of residence, with respect to a particular class of income for which benefits are claimed. In addition, this resident would have to be entitled under such a DTC to a tax rate that is at least as low as the rate applicable under the DTC in question.

33 Or those other few EU Member States with a zero rate in their DTC with the US.

However, if the dividends arise in Sweden the situation is different. Paragraph 7(h) takes into account the EU directives on inter-company dividends and Interest and Royalty payments. These directives provide for an exemption of WHT in many situations. If a US company receives such payments from a Swedish company and the US company is owned by an EU resident company, it will be treated as an equivalent beneficiary if it would have qualified for the directive exemption receiving the payment directly.[34]

The base erosion test, which is a part of both the ownership and derivative benefits test, might risk infringing the freedoms. It clearly excludes companies that are making substantial payments, which are deductible, to persons that are not residents of either Contracting State from qualifying for DTC benefits. This may adversely affect subsidiaries resident in Sweden and their parent companies in other MS if the parent companies have lent funds to their subsidiaries, for which the subsidiaries then pay interest back to the parent company. Interest is deductible for Swedish tax purposes against the profits of the company in question and if the amount of interest paid exceeds 50% of the gross income for that fiscal year, the subsidiary will not meet the requirement of the LoB clause tests.

2.2.4 Active trade or business test

Under this provision (Paragraph 4), a resident of one of the Contracting States that does not qualify for DTC benefits under paragraphs 2 and 3, may receive treaty benefits with respect to certain income that is connected to an active trade or business conducted in its state of residence. The term 'active trade or business' is not defined in the treaty. By subparagraph (b) this trade or business, carried on in the residence state must be substantial in relation to the activity in the source state. This is to avoid situations of treaty shopping where companies try to qualify for benefits by engaging in de minimis connected business activities.

2.2.5 Competent Authority relief

Paragraph 6 provides for the only subjective test in the LoB clause. A resident of one of the Contracting States may be granted benefits at the discretion of the competent authority of the state from which the benefits are claimed. The competent authority shall take into consideration whether the person claiming the benefit had as one of its main purposes the obtaining of the benefits under the DTC. The competent authority will consider the obligations of Sweden by virtue of its membership in the European Union in making a determination under Paragraph 6, according to the Technical Explanation. In particular any legal requirement for the facilitation of the free movement provisions shall be considered.

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34 Many MS have not renegotiated their treaties to reflect the position under the directives. See Hansson at p. 12.

Is this enough to avoid infringing Community law? Even though there is a requirement to consult, it is unclear how far reaching this requirement is. Hence, it is left to the discretion of a non-Member State authority to interpret and apply Community law to situations where it suspects tax avoidance, at the cost of its own tax base.[35] Even if the US competent authority were required to change its decision if questioned, in this author's view this is still to make Treaty freedoms conditional.[36]

3. Compatibility EC law v LoB clause

3.1 Freedom of establishment and Sweden-US LoB clause

The ownership and derivative benefits tests constitute special treatment of certain foreign nationals of other MS, who are exercising their freedom of establishment in another MS, and could be at risk of contravening the freedom of establishment. Companies established in Sweden may suffer unfavourable tax treatment when the LoB clause is applied due to their parent companies being established in other EU MS. This might appear to be a violation of the freedom of establishment.[37]

3.2 Free movement of capital and Sweden-US LoB clause

Art. 56 ECT protects shareholders regardless of the extent of their ownership. Art. 58 (1)(a) ECT expressly allows MS to apply domestic tax provisions that distinguish between resident and non-resident taxpayers and between domestic and foreign-source capital income. However, according to Art. 58(3) ECT national measures must not amount to arbitrary discrimination or a disguised restriction.[38] The concept of "Capital movement" is not defined in the ECT.[39] As regards dividends, the Court has held that even though the receipt of dividends of a national of one MS from a company in another MS is not expressly covered in the Annex, the examples are not exhaustive, and such dividends are in fact, "indissociable from a capital

35 Hansson, at p. 15.

36 The rights conferred by the freedoms are unconditional. A MS cannot make respect for them, subject to the contents of an agreement concluded with another MS, *Avoir fiscal*, para. 26.

37 Compare the situation in *Class IV of the ACT Group Litigation*.

38 On this issue see Christiana HJI Panayi, *"Treaty Shopping and other Tax Arbitrage Opportunities in the European Union: A Reassessment - Part 1"*, European Taxation, March 2006, p.109. In addition, see *Verkooijen* Case C-35/98 *Staatssecretaris van Financien v B.G.M. Verkooijen* [2000] ECR I-4071where the Court referred to this provision but then went on to apply the doctrine of the Rule of Reason.

39 See however the non-exhaustive list in Annex I to the 1988 Directive (88/361/EEC).

movement".[40] Does this apply in the same way to receipt of dividends from non-EU MS Countries? It has been suggested that AG Kokott in her Opinion in *Manninen*[41] and AG Geelhoed in the *FII* case[42] suggest a slightly narrower interpretation of free movement of capital with regard to third states than within the EU. In this author's view, no such limitation can be found in the wording of Art. 56 ECT. It is necessary to remember that residents of third states have free movement of only capital rights. A situation that would be regarded as, for example, providing services in a purely intra-Community setting will still be regarded in the same way by the Court in a Member State – third state situation. Hence, it falls outside the protective scope of the ECT and is not reclassified as a free movement of capital situation. Neither does the ECJ make a distinction between free movement of capital within the Community and in a Member State-third state situation.[43]

This difference in treatment can be applied to a company resident in Sweden receiving for example dividends from a company in the US,[44] on the basis that its owners (who cannot qualify as equivalent beneficiaries) are resident in other MS. This could amount to a difference in treatment of some foreign nationals with investments in Sweden. Subsequently, this might infringe the free movement of capital and make it less attractive for residents of other MS to invest in Sweden.

3.4 Compatibility with the non-discrimination requirement

There is no guarantee within the ECT that a cross-border situation in comparison with a purely domestic situation will be neutral, as stated in *Schempp*.[45] AG Geelhoed argues that this applies to Arts 43 and 56 in the field of direct taxation. Discrimination occurs only when an obstacle is created as a result of the rules of just one tax jurisdiction.[46]

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40 *Verkooijen*, paras 27-29. See also Opinion of Attorney General (AG) Geelhoed delivered on 23 February 2006 in Case C-374/04 the Class IV of the ACT Group Litigation Case, point 29.

41 Case C-319/02 *Manninen*. Opinion of AG Kokott delivered on 18 March 2004 in *Manninen*, points 77-79.

42 Case C-446/04 *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue*. Opinion of AG Geelhoed delivered on 6 April 2006 in the *FII* Case, point 121.

43 See *FII* para. 166. The Court talks about companies established in another State in general, not in Member States specifically, suggesting that it applies in the same way.

44 Which is a capital movement between a MS and a third state falling within the protective scope of Art. 56.

45 Case C-403/03 *Egon Schempp v Finanzamt München* [2005] ECR I-6421, para. 45.

46 See AG Geelhoed's opinion in *ACT IV*, point 46.

In the 'open skies' agreements a contracting state could deny the benefit of the agreements to an airline that is (mainly) owned and controlled by nationals of a non-contracting state, by the nationality clause.[47] It is interesting to note that the Court found that it was not the conduct of the US that gave rise to the discrimination but the nationality clauses, which acknowledged the right of the US to act in that way.[48] The Court held that by concluding and applying this agreement, it was the MS in question that had breached Community law.[49] The Court subsequently held that the inclusion of a specific provision obliging consultation prior to action by the US, in order to ensure that "all rights be exercised in accordance with Community law" did not clear the MS in question from breach of Community law.[50]

This would imply that the (Swedish) government could not successfully invoke the fact that the Technical Explanation, agreed to by the parties, includes a statement regarding the competent authority relief under paragraph 6, stating that "the competent authority will consider the obligations of Sweden by virtue of its membership in the European Union in making a determination…", to escape, or mitigate a possible breach of Community law.[51] Nor will it help that the competent authorities must, before denying a person benefits under the LoB clause, first consult the competent authority of the other contracting state.[52]

The LoB clause obliges the contracting states to treat those taxpayers that satisfy the requirements under the provision differently from those taxpayers that do not.[53] Does this difference in treatment, that the LoB clause provides for, amount to

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47 The ownership/shareholder test in the LoB provision function in much the same way as the nationality clause in the Open Skies agreements. Airlines that were not substantially owned and controlled by nationals of the contracting states could have their operating authorisation revoked, suspended or limited by the US. Companies that are not substantially owned and controlled by residents of the contracting states will not receive treaty benefits under the LoB clauses.

48 As noted by AG Tizzano in his opinion in C-466/98 *Commission v United Kingdom*, see points 60, 70-71, air transport is in contrast to direct taxation heavily regulated, largely covered by Community law and falls within the exclusive competence of the Community. The conclusion to be drawn might be that the doctrine of the *Open Skies* case law can be applied to direct tax cases but with careful consideration.

49 See for example case C-466/98 *Commission v United Kingdom* [2002] ECR I-9427, paras 51-52.

50 See case C-467/98 *Commission v Denmark* [2002] ECR I-9519, para. 105.

51 See United States Department of Treasury Technical explanation of the Protocol signed at Washington on September 30 2005.

52 See Hansson, p. 44.

53 For example, a company fully owned by Swedish residents will qualify for certain treaty benefits, whereas for shareholders resident in other MS it will be more difficult, if not impossible, to qualify.

discrimination under Community law? Discrimination, in the Community meaning, arises through the application of different rules to comparable situations or the application of the same or similar rules to different situations.[54] In the field of direct taxation, it can be said that two taxpayers are considered to be in a comparable situation if they have the same connection to the tax system of a MS. The most significant factor pointing to such a connection for companies is their liability to corporation tax.

First, the ECT prohibits a difference in treatment based on the nationality of individuals or companies. The main difference between the LoB clause at issue in the *ACT IV GLO* and the LoB clauses incorporated in the US DTCs lies in the way they were drafted. LoB clauses in recent US DTCs contain what amounts to a nationality clause.[55] This appears to be direct discrimination under the ECT.

Furthermore, as a general rule residents and non-residents are not in a comparable situation. There is however caveat to this rule.

3.4.1 Horizontal comparability – comparing two non-residents

The result of the ECJ reasoning in the *D* case when applied to a situation under the US LoB clause can be illustrated in the following way. An EU resident parent company[56] in relation to an UK parent company, each with a subsidiary in Sweden and sub-subsidiaries in the US, will not be in comparable situations. The UK company may via its subsidiary in Sweden be granted treaty benefits under the Sweden-US DTC such as a zero per cent WHT, since it meets the derivative benefits test.[57] An EU resident company will be granted a less favourable WHT rate. Another example is to look at this EU company in relation to a US parent company of a Swedish subsidiary. These situations are not comparable, following *D*.[58]

Even though Sweden, as a MS, grants less favourable treatment to some MS compared with other MS it is not a case of discrimination.[59] The distinction in a tax treaty between non-residents on the basis of the county of residence of their controlling shareholders, forms part of the balance and priority reached by the Contracting States in the exercise of their competence. An enquiry into the reasons

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54 See Case C-279/93 *Finanzamt Köln-Altstatt v Roland Schumacker* [1995] ECR I-225, para. 30.

55 As pointed out by Tom O'Shea, Lecturer Queen Mary College, University of London.

56 Not resident in Sweden, the UK or the Netherlands.

57 This since the UK-US DTC also contains a zero per cent WHT rate.

58 See Hansson, p. 36.

59 See AG Geelhoed's Opinion in *ACT IV*, point 100.

and justifications for this choice of balance – which may be appreciated only in the light of the broader balance reached in the extensive network of bilateral tax treaties that exists at present – does not fall within the proper scope of the Treaty's free movement provisions.[60]

3.4.2 Vertical comparability – comparing a resident and a non-resident

If we look at our EU resident parent company in relation to a Swedish parent company with a Swedish subsidiary, the two may be in a comparable situation, notwithstanding that the difference in treatment is based on a treaty provision. Such provisions, allowing for a difference in treatment between residents and non-residents, are within the scrutiny of the ECJ.[61] To the extent that, pursuant to a DTC, the source state exercises jurisdiction to levy income tax on outbound dividends distributed to non-residents, it must ensure that these non-residents receive equal treatment, including tax benefits, as residents subject to the same income tax jurisdiction would receive. This implies that in this situation, a non-resident such as our EU parent company should be granted the same tax treatment as the Swedish parent company when receiving dividends.

4. Justifications

Following the reasoning in ACT IV[62], the obstacles resulting from the LoB clause in the Sweden-US DTC in principle fall outside the scope of fundamental freedoms. However, as AG Geelhoed stated in his opinion in that case, one must still assess whether the requirements laid down to determine who will be eligible for tax benefits is based on relevant objective elements, suitable to justify the difference in treatment.[63]

Loss of tax revenue will never be accepted as a ground for justification.[64] Possible justifications are cohesion of the tax system[65] and the prevention of tax avoidance

60 See AG Geelhoed's Opinion in *ACT IV*, point 101.

61 G Kofler, "*Dancing with Mr D": The ECJ's denial of Most-favoured-nation treatment in the "D" case*, European Taxation, December 2005, p. 539.

62 According to AG Geelhoed there are three types of quasi-restrictions:
1. The division of tax jurisdiction (allocation of taxation powers);
2. Cumulative administrative compliance burdens for companies active cross-border, and;
3. Disparities between national tax systems. Opinion ACT IV GLO point 37.

63 See Hansson, p. 33.

64 See *Avoir fiscal*, Case 270/83 *Commission of the European Communities v French Republic* (*Avoir Fiscal*) [1986] ECR 273, para. 28 and *ICI*, Case C-264/96 *Imperial Chemical Industries (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695, para. 28.

and tax evasion.[66] How about the safeguarding of balance and reciprocity of a tax treaty as a justification ground?

4.4.1 The prevention of tax avoidance and tax evasion

Preventing tax avoidance is within the overriding reasons in the public interest that can justify a restriction on the fundamental freedoms. Although accepted in many cases, the national measures have often been found to be disproportionate or unsuitable. The legislation in question must be specifically designed to exclude 'wholly artificial arrangements aimed at circumventing national law' from a tax advantage.[67] Furthermore, the national provision must be aimed specifically at the situation that is considered abusive. A mere risk of tax avoidance is not sufficient.[68]

4.4.2 The safeguarding of balance and reciprocity of a DTC

The Court has stated in cases such as *Saint-Gobain*[69] and *Gottardo*[70] that preventing the disturbance of the balance and reciprocity of a bilateral international convention may constitute an objective justification. This may take the form of refusing to extend the categories of recipients of the benefits in that convention to nationals of other MS, which are not residents of a state party to the treaty. Even though accepted in principle, this justification has never been accepted in practice.[71]

As recognised in the *D* case, a tax treaty provision may "not be regarded as a benefit separate from the remainder of the Convention, but as an integral part of thereof and contributes to its overall balance".[72] As Mr D argued, the benefit in question was not reciprocal. Does the Court's statement then mean that not even non-reciprocal treaty benefits must be extended unilaterally? Probably not since the Court said in *Saint-Gobain*[73] that an extension of treaty benefits by Germany was possible without

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65 *Bachmann*. Maybe this ground is still accepted but only in a new form.

66 *Marks & Spencer*, Case C-446/03 *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* [2005] ECR I-0000.

67 See *ICI*, para. 26 and *Lankhorst-Hohorst*, para. 37.

68 See *Leur-Bloem*, Case C-28/95 *Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2* [1997] ECR I-4161.

69 *Saint-Gobain*, para. 60.

70 Case C-55/00 Elide *Gottardo v Istituto nazionale della previdenza sociale* (INPS) [2002] ECR I-413, para. 36.

71 See Hansson, p55.

72 *D.* para. 62.

73 *Saint-Gobain*, para. 59.

severely disturbing the functioning of the tax treaties involved. Be as it may, a strong argument can be made for the fact that anti treaty abuse provisions, such as the LoB clause, play a vital role for the functioning of tax treaties. It is a reciprocal provision and an essential part of the overall balance of a DTC.

4.4.3 Does the LoB clause meet the proportionality test?

Is the clause suitable to achieve the legitimate national interest and is it necessary for that purpose? The latter requirement is not fulfilled if there is a less restrictive measure available.[74] If the LoB clause catches not only the situations it is aimed at, but even legitimate business purposes, this must be balanced against the requirement that anti abuse provisions should be aimed only at wholly artificial arrangements. The LoB tests involve pure numeric tests[75] that lack flexibility to take into account the specific economic links of each individual case.[76] The possibility of a competent authority to grant relief is not sufficient to claim that the LoB clause provides for investigations on a case by case basis whether a situation is abusive or not. It only adds an element of legal uncertainty.[77] The active trade and business test on the other hand may be said to be flexible provisions that take into consideration the specific circumstances and economic links of each individual case.[78]

Often, the Court refers to Directive 77/799 on mutual assistance as a sufficient measure for achieving prevention of fiscal evasion or effective fiscal supervision, leaving other national measures disproportionate. This measure is however not available in a situation involving a third state. Maybe this affords the MS more leeway in determining which measures that are necessary to achieve the public interest pursued.[79]

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74 This was the problem in *Marks & Spencer* (see paras 55-59). The Court established that the national measure pursued legitimate public interests in conformity with Community law, and the national measures were even suitable for achieving these public interests, however the restriction nonetheless went beyond what was necessary in order to attain the objectives pursued.

75 Such as the ownership test.

76 See Hansson, p. 51.

77 S. Rienks, "*An EU View on the new Protocol to the tax treaty between the US and the Netherlands*", Intertax 2004, Vol 32 Iss 11, p.576, C.H.J.I. Panayi, "*Treaty shopping and other tax arbitrage opportunities in the European Union: a reassessment- Part 2*", European Taxation, April 2006, p. 143

78 See Hansson, p. 52.

79 Ibid. p. 53.

5. Conclusion

Do the EC freedoms apply to the relations between the Swedish parent and its US subsidiary, in a case where an ultimate parent company of a MS has established a subsidiary in Sweden with a sub-subsidiary in the US? Looking at it from the Swedish resident company's viewpoint, Art. 56 ECT applies to capital movements between MS and non-MS. Sweden is furthermore under the obligation not to treat the Swedish resident company differently on the basis of where its parent company is resident. At least not in a way that hinders or makes it less attractive for the Swedish resident company to exercise its freedom of establishment. The Swedish company falls under the protective scope of Art. 43 and should not be treated differently from a company with its parent company resident in Sweden. However, we must bear in mind that Art. 43 covers activities within the Community, and that the purpose of those activities is to abolish all obstacles to the freedom of establishment in a MS. It could be argued on behalf of the Swedish government that Art. 43 does not contain an obligation for the MS to ensure that all resident companies do not encounter discrimination when exercising their activities in a non-MS. Art. 43 is not a guarantee that the exact same conditions will apply in pursuing their activities in a non-MS.

A company will not be denied treaty benefits if it does not also conduct base eroding transactions, or fails to meet any other of the tests set out in the LoB clause. This difference in treatment of individual shareholders might place non-Swedish parent companies at a disadvantage. The LoB clause also makes the shares in a US sub and a Swedish sub more costly and less attractive to EU investors in MS who do not have a similar provision in their DTC with the US.

The LoB clause makes it less attractive for an EU corporation in another MS to invest in Sweden if the ultimate goal is to invest in the US. However, the LoB clause does not treat this EU company any differently from resident parent companies in respect of business activities carried out by subsidiaries in Sweden. On the other hand, the Swedish and the EU company that cannot qualify for treaty benefits are put in a less favourable position than other qualifying resident companies in respect of dividends flowing from shareholdings in the US.

LoB clauses in a DTC drafted in accordance with the OECD Model might cause a difference in treatment especially concerning subsidiaries. A subsidiary of a company resident in another MS usually has the same connection to the tax system as a subsidiary of a company resident in the same MS. Hence, these two are in a comparable situation. The effect of the LoB clause is that these two are treated differently depending on the residence of the beneficial owner of a payment. The same applies in the case of permanent establishments as these usually have the same connection to the tax system as a resident subsidiary.

If LoB clauses are drafted in a general way and are not specifically aimed at combating wholly artificial arrangements aimed at circumventing the application of the legislation of the MS in question, the justification of preventing tax avoidance would, probably, not pass the proportionality test. However, the LoB clauses following the US Model are more specific. They provide for several tests to ascertain that many genuine intentions are not caught by the LoB clause. Still, according to the ECJ, treaty shopping is not considered abusive in a Community context. Therefore, even the US Model LoB clauses might fail the proportionality test as being too general. At least, making nationality the basis for denying treaty benefits is incompatible with the ECT.