EC LAW AND DOUBLE TAXATION AGREEMENTS

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This article gives an account of the current state of ECJ case law in the area of direct taxation, with particular reference to double taxation treaties, and concludes that the growing litigation in the ECJ suggests a need for discussion of tax treaty issues at a political level in a Community forum.

The OECD Model and Bilateral Treaty System

An important part of the international tax system are the approximately 2000 mainly bilateral tax treaties which exist world-wide. Within the EU there are around 100 treaties in force covering all but a few bilateral relations between Member States. Most EU treaties are based on the Model Treaty published by the OECD (although some of the older treaties pre-date the Model). First published as a draft convention in 1963, and revised in 1977 and 1992 and regularly updated since, the Model has proved to be highly influential in determining the content of treaties both within and beyond the OECD area. Responsibility for the Model lies with the OECD Committee on Fiscal Affairs, consisting of senior tax officials from the OECD countries. The articles of the Model are accompanied by detailed commentaries. The world-wide recognition of the Model and its incorporation into the majority of bilateral conventions have helped make the commentaries a widely accepted guide to the interpretation of bilateral conventions.

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As agreements between States tax treaties are subject to the rules of public international law, in particular the Vienna Convention. Their status as a matter of national law varies. In France for example tax treaties prevail over domestic law under constitutional rules. In other countries, such as the United Kingdom, the legislator is free to override treaties - nevertheless in the absence of a clear intention the courts will often assume an intention to observe the treaty.

Traditionally the primary purpose of treaties is to eliminate or reduce double taxation, with the ancillary goal of removing discrimination against foreign nationals or residents; however, an increasingly important further aim is the elimination of tax evasion or avoidance. International tax terminology distinguishes between juridical and economic double taxation: juridical double taxation occurs where two States tax the same person on the same income (for example, income received by a resident of one country from employment in another), international economic double taxation where both States tax the same income but in the hands of different persons (for example, income taxed at the corporate level and again at the shareholder level or in the hands of two associated companies). The OECD Model is mainly concerned with the elimination of juridical double taxation, although treaties do contain provisions to reduce economic double taxation. Economic double taxation is however more difficult to eliminate at an international level without reform of tax systems and alignment of tax bases.

The OECD Model applies to taxes on income and capital. Under Article 1 of the Model the Convention applies to persons who are residents of one or both Contracting States. The term "resident", which is extensively defined in Article 4, means primarily a person liable to tax in a State by reason of his domicile, residence, place of management or other criterion of a similar nature - it does not include persons liable to tax in a State only on income from sources or capital there. Thus, a company will not be resident in a State merely by virtue of having a (secondary) permanent establishment there since it will normally be taxable only on the income of the permanent establishment. Thus permanent establishments are generally not entitled to treaty benefits (although they are covered by a specific non-discrimination rule).

In recent years there has been increasing concern about the abuse of treaties, and various devices are used to combat this. Some countries, in particular the United States, have adopted the practice of reinforcing the residence requirement with limitation of benefits clauses destined to avoid "treaty shopping", i.e. the situation where residents of a third country who do not have the benefit of the treaty use a company resident of one of the Contracting States as a conduit. Typically such clauses in US treaties require the resident either to conduct an active business in the country or to show both that the income is not substantially used to pay interest or royalties to persons not entitled to benefits and that over 50% of the shares are owned by qualifying persons, normally residents of one of the Contracting States.

Juridical double taxation is eliminated under the Model by allocating and/or limiting the taxing rights of the Contracting States. The way this is done depends on the type of income or capital. Income and capital is divided into three classes:

- Income and capital that may be taxed without limitation in the source State;[2]
- Income and gains which may be subjected to limited taxation in the source State;[3]
- Income and gains which may not be taxed in the source State (and as a rule are solely taxable in the State of residence of the taxpayer).[4]

Juridical double taxation is eliminated by the Model where taxing rights are allocated exclusively to the State of residence and can arise only where there is unlimited or limited taxation in the source State. In such cases the State of residence is obliged to give double taxation relief either by exempting the income or by crediting the foreign tax paid.

The Relationship Between Community Law and Tax Treaties

By virtue of the principle of the supremacy of Community law both primary and

2 Income and gains from immovable property; profits and gains from a permanent establishment; income from activities of artists and sportsmen exercised in that State; income from independent services attributable to a fixed base and gains from the alienation of the fixed base; directors' fees paid by a company resident there; remuneration from the private sector in the source State; certain remuneration and pensions from government service.

3 Dividends where the holding is not connected with a permanent establishment or a fixed base: 5% of the gross amount where the beneficial owner is a company holding directly at least 25% of the company paying the dividends; 15% of the gross amount in other cases; interest where the holding is not connected with a permanent establishment or a fixed base : 10% of the gross amount, except for any interest paid in excess of the normal amount.

4 Royalties; gains from the alienation of shares and securities; private sector pensions; payments received by students for their education; capital represented by shares or securities; business profits and income from independent services not attributable to a permanent establishment or a fixed base in the source State. Profits from the operation of ships or aircraft are taxable solely in the State of the place of effective management of the enterprise.

secondary Community law take precedence, as a matter of Community law,[5] not only over domestic tax rules but also over double taxation conventions, including prior conventions, concluded between Member States.[6] The reason for that is clear: Community law would otherwise be a dead letter (just as it would be if it did not take precedence over domestic provisions). In proceedings based on the direct effect of a Community provision national courts must therefore set conflicting articles of such conventions aside.

The position regarding conventions concluded with third countries is more complex. The first paragraph of Article 307 (ex 234) of the Treaty preserves, in accordance with principles of international law, rights and obligations arising from agreements concluded before the entry into force of the Treaty between one or more Member States, on the one hand, and one or more third countries on the other; at the same time it requires the relevant Member State(s) to take appropriate steps to eliminate any incompatibilities, imposing a collective duty on Member States to assist each other to that end and to adopt, where appropriate, a common attitude.[7] An undecided point is whether a Member State would be able to rely on the first paragraph of Article 307 (ex 234), or at least the principle underlying it, in order to resist the application of a provision of Community secondary law, e.g. a Directive, adopted subsequent to a convention concluded with a third country. From a legislative perspective the practical answer would be to insert, where appropriate, a provision in the Community instrument preserving existing treaties.

The effect of Community provisions in the sphere of direct taxation is generally to relieve taxpayers from tax.[8] Since tax treaties do not prevent a Contracting Party from adopting more favourable treatment towards a taxpayer, the conflict will generally be with taxing rights asserted under domestic provisions which are consistent with, or are merely limited by, bilateral treaty provisions. In other words the problem will generally be that a bilateral treaty does not go far enough in

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5 As a matter of national law problems may arise where, as for example in France, double taxation conventions have a higher status than ordinary laws under constitutional rules.

6 See Case 270/83 *Commission v France* [1986] ECR 273. See also Case 10/61 *Italy* [1962] ECR 1, Case 121/86 *Conegate* 1986 ECR 1007, Case 286/86 *Deserbais* [1988] ECR 4907, Joined Cases C-241/91 and C-242/91 [1995] ECR I-743.

7 See Case C 158/91.

8 A notable exception is the Proposed Directive on taxation of savings which requires Member States not opting for the information system to impose a withholding tax on interest payments made to residents of other Member States.

extending benefits to non-residents.[9]

A comparison of the non-discrimination rule in tax treaties and the EC equal treatment principle and fundamental freedoms

Non-discrimination in Tax Treaties

Article 24, the non-discrimination article in the OECD Model, has been described by the eminent international tax professor, Kees van Raad, as "an incoherent collection of rather narrow clauses". Article 24 (1) and (2) prohibit discrimination on grounds of *nationality*. Under Article 24(1) and (2) of the Model nationals (and resident stateless persons) of a Contracting State must not be subject in the other Contracting State to any taxation or connected requirement which is other or more burdensome than that to which nationals of that other State in the same circumstances, in particular with respect to residence, are subject. The commentary to Article 24(1) makes it clear that residents and non-residents are not considered to be in the same circumstances for this purpose; the words "in particular with respect to residence" were added in 1992 to clarify that point. The scope of the prohibition is therefore relatively limited. A contracting State cannot be required to extend to non-resident nationals of another contracting State the same treatment as it gives to resident nationals - it merely undertakes to give the same treatment as is available to its own nationals who reside in the other State.

The remaining paragraphs are broader inasmuch as they concern discrimination based on *residence* rather than nationality. They are however aimed at specific instances of discrimination. Article 24(3) is concerned with the situation where an enterprise of the other Contracting State has a permanent establishment in the source State; it prohibits the latter from levying tax on the establishment which is less favourable than that levied on its own enterprises carrying on the same activities. Article 24(4) provides in principle for the deductibility of interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State on the same conditions as if paid to a resident of the first State. Article 24(5) prohibits more burdensome taxation or connected requirements for enterprises whose capital is wholly or partly owned or controlled directly or indirectly by residents of the other Contracting State.

As regards Article 24(3), both the article itself and the commentary contain some important limitations : for example, the second sentence of Article 24(3) excludes

9 See however the discussion of the *Hoechst* litigation below.

any obligation to grant personal allowances, reliefs and reductions on account of civil status or family responsibilities, the assumption being that these will be granted in the State of residence; Contracting States are left to decide whether a dividend tax credit should be extended to permanent establishments; and while in general the same scales and rates should apply, some countries do not consider themselves obliged to grant the lower of two rates under a split-rate system. Moreover, the commentary to Article 24(5) indicates that it relates only to taxation of enterprises and not of the non-residents owning or controlling their capital.

The limits of the prohibition can be illustrated by two examples of rules held not to violate treaty non-discrimination articles: the refusal of the US to extend special tax rate schedules to non-residents; Germany's refusal to allow relief from tax on the reorganisation of a partnership into a limited company where the partners were non-resident (the relevant treaty article not requiring rules applicable to persons subject to unlimited liability to be applied to persons subject to limited liability).

The Principle of Equal Treatment and the Fundamental Freedoms

Articles 39 (ex 48), 43 (ex 52) and 49 (ex 59) of the EC Treaty, providing for the free movement of workers, freedom of establishment and freedom to provide services, have traditionally been seen by the Court as giving specific expression to the prohibition of discrimination on grounds of nationality in Article 6 of the Treaty, itself a manifestation of the general principle of equal treatment. Furthermore Article 56 (ex 73b), in conjunction with Article 58 (ex 73d), prohibits discriminatory restrictions on the free movement of capital and payments.

The notion of discrimination is broadly construed in EC law and encompasses not only overt discrimination on grounds of nationality but also covert discrimination, i.e. forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result. Where the criteria in practice target a group comprising predominantly foreign nationals for adverse treatment, the national rule in question will be considered to discriminate on grounds of nationality unless the adverse treatment is justified by objective factors other than nationality and is proportionate to the aim pursued by the rule. The proportionality test is the sting in the tail. Generally speaking it is applied strictly by the Court without any attempt - at least overtly - to balance the degree of strictness of the test against the severity of the restriction.

In a tax context the criterion of differentiation under national rules is generally residence. A rule adversely affecting non-residents may be presumed to affect more foreign nationals than nationals and will therefore be considered discriminatory unless the Member State concerned can show that it is justified by objective factors and meets the proportionality test.[10] In other words, in contrast with the OECD Model, under which it is assumed that a non-resident is in a different position and can legitimately be subject to different treatment unless specifically forbidden by a non-discrimination rule of Article 24, in EC law the onus is on a Member State to show that the non-resident's situation is sufficiently different to warrant the different treatment. Moreover, under the Treaty the equal treatment principle applies to all forms of cross-border trade, movement and investment.

EC law may however go further still - discrimination is not the only analytical tool used by the Court. In its case law on Article 28 (ex 30) concerning the free movement of goods the Court held as long ago as 1974 in *Dassonville*[11] that Article 28 covered:

> "All trading rules enacted by Member States which are capable of hindering directly or indirectly, actually or potentially, intra-Community trade".

Since such a broad principle would catch all restrictions, even those arising simply from disparities between national rules, the Court added the qualification in *Cassis-de-Dijon*[12] that such restrictions had to be accepted in so far as they were necessary to satisfy mandatory requirements relating *inter alia* to the effectiveness of fiscal supervision, public health, fair trading and consumer protection.

Thus was borne what is generally referred to as the "restriction-based" approach. Following earlier indications the same approach was unequivocally transposed to services in *Säger*,[13] where the Court held that Article 49 (ex 59) of the Treaty required not only the elimination of all discrimination on grounds of nationality but also the abolition of any restriction, even if it applied without distinction to national providers of services and to those of other Member States, where it was liable to prohibit or impede the activities of a services provider in another Member State where he lawfully provided similar services. Such a restriction could be justified only by imperative reasons relating to the public interest in so far as that interest was

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10 The equal treatment analysis may also be contrasted with the national treatment obligation in Article XVII of the GATS agreement concluded in the framework of the WHO, which focuses less on whether there is formally different or identical treatment than on whether a measure modifies conditions of competition in favour of a Member's national service suppliers.

11 Case 8/74 [1974] ECR 837.

12 Case 120/78 [1979] ECR 649.

13 Case C-76/90 [1991] ECR I-4221.

not directly protected by the rules of the provider's state of establishment.

Restriction-style language has predominated in the services case law, even where discrimination was or could have also been found, and indeed the distinction is not always clear-cut. The Court seems initially to have been more reticent about extending the same approach to the case law on persons, relying instead on a very broad notion of covert discrimination. Even in that area, however, examples now abound, and indeed the *Bosman*[14] ruling, concerning Article 39 (ex 48), is probably the broadest application of any freedom article.

Beginning with its ruling in *France*[15] the Court has extended its general case law to the area of direct taxation, finding national tax rules to be unlawful in a number of cases. Until recently the Court's approach was based exclusively on equal treatment. The Court considered whether the national rule imposed a different (higher) tax burden on persons in a cross-border situation than on the relevant domestic comparator (either directly or indirectly by refusing some advantage granted to the domestic comparator) and, if so, whether the difference in treatment was justified. The same approach was applied to procedural differences of treatment, i.e. the way in which the tax was levied. Examples of cases where there was held to be a discriminatory tax burden include:

> a dividend tax credit granted to companies resident in France but refused to the branch of a company having its seat abroad;[16] a refund of overpaid income tax granted by Luxembourg to permanent residents but refused to taxpayers leaving the country during the tax year;[17] personal reliefs granted by Germany to residents but refused to non-residents even where they could not benefit from such reliefs in their State of residence;[18] a business relief (a tax deduction for transfers of funds to a pension reserve) granted by the Netherlands to residents but refused to non-residents;[19] a higher rate of tax

14 Case C-415/93 [1995] ECR I-4921.

15 Case 270/83 [1986] ECR 273.

16 *France*, cited above.

17 Case 175/88 *Biehl* [1990] ECR I-1779

18 Case C-279/93 *Schumacker* [1995] ECR I-225.

19 Case C-80/94 *Wielockx* [1995] ECR I-2493.

imposed by the Netherlands on non-residents than residents;[20] refusal of loss and other relief for consortia with predominantly foreign subsidiaries.[21]

In several of the cases there was also held to be procedural discrimination.

Two particular points about the Court's analysis are worth noting. First, the Court approaches the comparison of tax burdens on a tax-by-tax basis. Thus in *France* it expressly declined the invitation of the French Government to consider whether the overall treatment of a branch of a foreign company was worse than that of a subsidiary - it confined itself to a comparison of the annual taxation of the company's profits. As already noted, there is disagreement between OECD members as to the scope of the non-discrimination obligation with respect to permanent establishments. As a matter of EC law differences of treatment will be lawful only if on close scrutiny they represent a direct and proportionate response to differences in the positions of permanent establishments and resident subsidiaries. There is therefore considerable potential for conflict in this area.[22]

Secondly, in determining whether a difference of treatment, in particular a higher tax burden, is justified, it is relevant to take account of the taxpayer's position in both of the Member States concerned, including his treatment under any relevant treaty provisions. Thus, if a taxpayer receives full personal reliefs in his State of residence, the refusal of such reliefs by the source State is justified.[23] Conversely, a source State cannot argue that the imposition of a higher rate of tax on income arising in the source State is justified by the need to preserve the progressivity of the tax system if a taxpayer is subject to progressivity on the income in his State of residence under the relevant tax treaty. [24]

It might be thought to follow that it is relevant in determining whether there is

20 Case C-107/94 *Asscher* [1996] ECR I-3089.

21 Case C-264/96 *ICI,* judgment of 16th July 1998.

22 Further guidance on this issue may be provided by the currently pending *San Gobain* case, concerning Germany's refusal to extend to a permanent establishment of a French company privileged treatment of dividends received from non-member countries granted to resident companies. It seems doubtful whether the difference of treatment in issue can be justified.

23 *Schumacker*, cited above.

24 *Asscher*, cited above, though arguably both the residence State, if it is an exemption State, and the source State need to apply a progressivity reservation if one is to arrive at a tax burden comparable to the burden which a resident of the residence country or a resident of the same country incurs who derives the same overall income from one country.

discrimination also to consider taxes paid by the taxpayer in another State. Although similarly focusing on the taxpayer's overall position, technically that argument raises the different - and rather more controversial - issue of whether identical treatment, i.e. the same tax burden, is to be considered discriminatory because the Member State is treating identically two persons in materially different positions (the person in a cross-border situation being potentially subject to tax in two jurisdictions).[25] If so, a Member State's taxing rights over persons in cross-border situations would effectively be curbed unless it had negotiated a tax treaty allowing it to assert its full rights without causing double taxation. Even if one accepted that analysis, it is difficult to see how it could be applied to economic double taxation arising from different measurements of profit.

The Court's general tendency to move to a restriction-style analysis was reflected in the *Safir*[26] ruling of last year. An interesting feature of that case is that the Swedish rules in question were held to be unlawful even though the taxpayer, a Swedish resident receiving cross-border services from a United Kingdom company, was in all probability subject to a lower Swedish tax burden than a taxpayer receiving domestic services. Ms Safir concluded a life insurance policy with the United Kingdom subsidiary of the Swedish company Skandia. Had she concluded a policy with a Swedish insurer she would have borne tax indirectly in the form of a yield tax on the insurance fund. Because Sweden is unable to tax foreign insurance funds in that way, it levies a compensatory tax on premiums paid to foreign insurers, subject to double taxation relief for equivalent foreign taxes. Following her application for relief the Swedish authorities reduced the amount of tax on the premium by one half to take account of the United Kingdom tax paid by the subsidiary. Ms Safir appealed, prompting the Swedish court to seek a ruling on whether the Swedish arrangements were compatible with the Treaty.

The Court observed first that Article 49 (ex 59) of the Treaty precluded the application of any national legislation which, without objective justification, impeded a provider of services from exercising the freedom to provide them. In the perspective of a single market and in order to enable its objectives to be attained Article 49 of the Treaty likewise precluded the application of any national legislation which had the effect of making the provision of services between Member States more difficult than the provision of services exclusively within one Member State.

The Court then went on to list a number of impediments created by the rules

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25 The principle of equal treatment precludes not only different treatment of persons in an identical position but also identical treatment of persons in different positions.

26 Case C-118/96 *Safir* [1998] ECR I-1897.

including:

> the requirement for policyholders with foreign insurers to register with, and declare payments to, a central body;
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> the requirement to pay the tax on the premium themselves, with the attendant adverse cash-flow consequences;
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> the disadvantage that a surrender after a short period could be more costly for the policyholder;
>
> the requirement to provide precise information concerning the foreign tax to which the company was subject unless the authority already had the information;
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> the fact that the determination of the tax applicable depended on an assessment by the tax authorities.[27]

The Court then considered whether the restrictions were justified. The Swedish Government contended that the procedures were designed to allow double taxation relief to be granted in order to comply with the equal treatment principle. The Court rejected that contention on the ground that the Swedish rules were not fully effective in giving relief because the foreign tax had to amount to at least one quarter of the Swedish tax in order for there to be a 50% exemption and at least one half of the tax for full exemption. Owing to that threshold foreign policies were in most cases liable to be taxed more heavily than domestic policies.

Finally, the Court added that the Swedish legislation made it difficult, if not impossible, for the national court to compare the yield tax on domestic policies with the premium tax on foreign policies.

What is interesting is that the Court did not confine itself to a comparison of the Swedish tax burdens on domestic and cross-border policies (although it pointed out that such a comparison would be difficult). Instead, using the restriction-style language now common in services cases, it bypassed any such comparison and simply asked whether the national legislation "had the effect of making the provision of services between Member States more difficult than the provisions of services exclusively within one Member State". Unsurprisingly - given that two tax systems were involved - the Court was able to identify numerous “restrictions” which would

27 The Swedish authorities had adopted different decisions with respect to policies with UK life assurance companies although the UK rules had not changed.

not exist in a purely domestic context.

But does the existence of double taxation itself constitute a restriction? And to what extent can additional procedures designed to relieve double taxation be justified? Unfortunately the judgment does not answer either of these points. This is partly due to the arguments presented. Surprisingly Sweden seems to have conceded that it was required to credit the United Kingdom tax in order to comply with the equal treatment principle. As already explained, previous case law had established no such principle. One might therefore have expected it to argue instead that the crediting of UK taxes went beyond its obligation not to discriminate (its sole obligation under Community law) and that the different procedures applied to foreign policies were necessary for that purpose. The Court's reply is curious. Although distancing itself from the Swedish Government's concession, it implied that there was an obligation to credit the UK tax by replying that the Swedish rules were not fully effective for that purpose.[28] In short, the reader is left with a strong suspicion of disagreement on the issue among the judges.

In conclusion, although it is difficult, particularly following *Safir*, to advise with confidence on the precise extent of Member States' obligations, the EC Treaty unquestionably goes further than double taxation conventions in requiring the elimination of obstacles to cross-border movement and investment. Further litigation may be expected in particular in the following areas:

- higher tax rates and refusal of reliefs for (non-resident) frontier workers and traders: as shown by *Schumacker*, the situation of such persons is not always adequately dealt with by domestic and treaty provisions;

- refusal of reliefs for (resident) migrant workers and traders: such taxpayers are liable to be affected in particular by rules refusing deductions in respect of services received from abroad under long-term arrangements such as insurance and pensions;

- restrictions on cross-border services (for example adverse treatment of cross-border loans and other financial services, royalties, leasing, life assurance and pensions);

- refusal of benefits under treaty and domestic rules and higher tax rates for permanent establishments: as already indicated, the equal treatment principle probably goes further than requirements under tax treaties;

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28 In any event that reply was not strictly relevant to the issue was surely whether the restrictions imposed were necessary for that purpose.

- rules aimed at the use of conduit and base companies and other anti-abuse rules such as CFC and thin capitalisation legislation: such rules are likely to infringe Article 43 (ex 52) of the Treaty unless they can be shown to serve a legitimate purpose and are proportionate;

- differential treatment of equity investment under corporate and income tax systems: see the discussion of the *Hoechst* litigation below;

- withholding taxes on interest and royalty income: gross source taxation may be discriminatory in certain circumstances;[29]

- instances of double taxation.

Member States' Power to Conclude Tax Treaties with Each Other

Article 293 (ex 220) of the Treaty envisages that Member States will enter into negotiations with each other in order to secure the abolition of double taxation for the benefit of their nationals. The scope of that provision and the Member States' treaty-making powers in the absence of a multilateral convention entered into under that article were recently considered by the Court in *Gilly*.[30]

Mr and Mrs Gilly are teachers who reside in France, Mr Gilly teaching in a French school and Mrs Gilly in a German school. Mr Gilly is a French national, Mrs Gilly a German national also holding French nationality by virtue of her marriage. Under the Franco-German convention income from dependant work is normally taxable solely in the State of performance, subject to an exception for frontier workers who are to be taxed in their State of residence. However, taxpayers receiving remuneration and pensions from the public sector are in principle taxable in the paying State unless they are nationals of the other State (without being at the same time nationals of the paying State) in which case remuneration is taxable only in the State of residence. Under the convention Mrs Gilly, as a dual national receiving public service remuneration, was taxed in Germany. Her income was effectively exempt with progression in France.

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29 As explained above, it is common for a source country to retain the right to limited source taxation under tax treaties on certain income payments to non-residents, in particular interest. The source taxation is exercised by way of a reduced treaty withholding tax rate. Such taxation, imposed on a gross basis without the possibility of any proportionate deductions against the income, may be discriminatory in so far as deductions would be allowed to a resident taxpayer against similar income.

30 Case C-336/96 [1998] ECR I-2793.

The first question put by the referring French court was whether the second indent of Article 293 of the Treaty had direct effect. The Court, referring to its judgment in *Mutsch*,[31] replied in the negative. Article 293 was not intended to lay down a legal rule directly applicable as such, but merely defined a number of matters on which Member States were to enter into negotiations with each other "so far as is necessary". Its second indent merely indicated the abolition of double taxation within the Community as an objective of any such negotiations. Although the abolition of double taxation within the Community was included among the objectives of the Treaty, it was clear from the wording of that provision that it could not itself confer on individuals any right on which they could rely before their national courts.

The French court also asked whether the different allocation of taxing rights under the Franco-German convention for different categories of workers, including provisions based on nationality, were compatible with Article 39 (ex 48) of the Treaty. The Court noted that, while abolition of double taxation within the Community was one of the objectives of the Treaty, other than the Arbitration Convention no unifying or harmonising measure for the elimination of double taxation had yet been adopted at Community level nor had the Member States yet concluded any multilateral convention to that effect under Article 293 of the Treaty. The Member States were accordingly competent to determine the criteria with a view to eliminating double taxation and had concluded many bilateral conventions based in particular on the OECD model conventions. Although the criterion of nationality appeared as such in the convention, differentiation on that basis could not be regarded as constituting discrimination prohibited under Article 39 of the Treaty. It flowed, in the absence of any unifying or harmonising measures at Community level, from the Contracting Parties' competence to define the criteria for allocating their powers of taxation as between themselves with a view to eliminating double taxation.

The Court's conclusion that the second indent of Article 293 does not have direct effect is in itself unsurprising. Nevertheless, a more thorough discussion of the double taxation issue either in *Gilly* or *Safir* (given shortly before) would have been useful.

The *Gilly* ruling distinguishes implicitly between allocation and exercise of tax jurisdiction. The mere allocation of jurisdiction to a State on the basis of nationality[32] or residence as part of the arrangements for avoiding double taxation does not of itself entail direct or indirect discrimination on grounds of nationality. The question

31 Case C-137/84 [1985] ECR 2861.

32 The conclusion that tax rights may be based overtly on nationality perhaps seems less surprising for companies whose "nationality" and tax residence often coincide in any event.

seems rather to be whether the manner in which such jurisdiction is implemented or exercised is consistent with the jurisdiction claimed. Thus, if a State claims the right to tax employment income of a non-resident arising within its territory because of his nationality (or dual nationality), it must accord all advantages which flow from the taxing rights claimed (e.g. deductions in respect of the income allowed to residents, personal reliefs in certain circumstances). [33]

For present purposes the most important point established by the ruling is that, in the absence of uniform rules, Member States are free to enter into bilateral arrangements dividing up taxing rights between themselves with a view to removing double taxation. It follows that the arrangements may vary for the same category of taxpayer according to the treaty in question; in other words, there may be differences in source and residence jurisdiction under different treaties.

Nevertheless it is unclear whether every difference in the privileges granted under tax treaties can be explained on that basis. In issue in the *Hoechst* and *Metallgesellschaft* cases, currently pending in the ECJ, is whether the treatment of distributions made to German parent companies by their United Kingdom subsidiaries entails a restriction of the German parent companies' freedom of establishment contrary to Article 43 (ex 52) of the Treaty. The case, which concerned the UK legislation in force prior to its amendment this year, raises a number of distinct issues. First, the German-owned group is not entitled to the group income election which may be claimed by a United Kingdom group, allowing postponement of the payment of ACT until the profits are distributed out of the group. The plaintiffs argue that, although they were ultimately able to set off the ACT paid, they incurred a cash flow loss because the subsidiaries were required to pay ACT at the moment of the distributions to the German parent companies. Secondly, they argue that, if they do not have a remedy in respect of that loss, they are entitled to a tax credit, or at least to a credit equal to those granted to parent companies under certain of the United Kingdom treaties. Under domestic legislation non-resident parent companies are denied the tax credit available to a domestic parent company; under certain treaties, however, e.g. the treaty with the Netherlands, the non-resident parent company receives a half tax credit subject to a reduced rate of tax on the total of the dividend and the credit. The plaintiffs put forward two distinct arguments: first, they contend that the refusal of the tax credit discriminates in favour of UK groups and is not necessary to protect the coherence of the UK system, as is demonstrated by the fact that partial credits are granted under certain treaties; secondly, they argue that the grant of partial credits under some treaties but not under others constitutes unlawful discrimination between

33 It is in fact far from clear whether the German treatment of Mrs Gilly was justified: see Case C-391/97 *Gschwind*, currently pending.

nationals of other Member States. Treaty freedoms encompass a most favoured nation principle in relation to direct taxes

The issues raised by the case are difficult. In general the UK rules do not impose a higher UK tax burden on profits distributed to non-residents - indeed the problem is (or was - they have since been amended) that they impose the same UK burden, with resultant economic or juridical double taxation. Thus, profits distributed to a German individual shareholder through a German parent are subject to the same UK tax burden as profits distributed to a UK basic-rate taxpayer. However, whereas a UK basic rate taxpayer suffers no further taxation on the dividend, a German shareholder is taxable in full. Economic double taxation is reduced at a domestic level but not at an international level. In the context of classical systems the Parent-Subsidiary Directive removed the international economic double taxation occurring at the corporate level within groups by eliminating withholding taxes on cross-border dividend distributions to parent companies. Thus domestic and foreign shareholders incur the same tax burden at the corporate level (and both are taxed at the shareholder level). Under an imputation system, however, it is not possible neatly to sever company and shareholder taxation. In negotiating the Directive Member States operating such systems therefore sought to preserve the right to impose the source taxation necessary for the retention of their systems.

It cannot however be ruled out, particularly in the light of recent trends, that the Court will by-pass comparisons of tax burdens and simply conclude that the UK system entails a disproportionate restriction on the parent company's freedom of establishment, at least to the extent that a lower burden is imposed under certain treaties through the grant of partial credits. In any event the timing of the charge, i.e. at the moment of distribution rather than at the normal date for payment of the mainstream liability, seems difficult to justify given that the German parent company does not obtain a tax credit.

Whether the Court will find it necessary to deal with the issue of discrimination between nationals of other Member States remains to be seen - it seems likely that the Advocate General will at least feel it necessary to do so. If - as seems likely - Article 12 (ex 6) and/or 43 (ex 52 of the Treaty covers such discrimination (and not merely discrimination in favour of a Member State's own nationals), then the onus will be on the United Kingdom to demonstrate that the different treatment is based on objective factors other than nationality and is proportionate. While following *Gilly* it seems that Community law permits differences in the allocation of taxing rights between the residence and source States, it is less clear that the same applies to differences in concessions designed to relieve economic double taxation. Such differences are not or at least not as obviously inherent in the principle of bilateralism accepted by the Court. Reciprocity in the extension of benefits seems unlikely to be an acceptable justification. The strongest argument for the UK would appear to be that it is not possible - and is unrealistic - to divorce individual provisions from the overall negotiated settlement . That argument too however is not without its problems. It is to be hoped that the Court's ruling does cover all the issues raised by the litigation as this would provide much needed clarification in this difficult area.

External Competence

Only a limited number of EC Treaty provisions expressly provide for the conclusion of international agreements by the Community. However, in a series of cases[34] the Court has recognised that the Community's treaty-making power also arises by implication from other provisions of the Treaty and from measures adopted, within the framework of those provisions by the Community institutions. The Court has developed the principle of parallelism between internal and external competence: the Community has capacity to enter into an international agreement in a certain domain provided that the Treaty bestows the Community with internal capacity in that domain and such participation is necessary for the attainment of Community objectives.

Thus the Community's external competence in the sphere of direct taxation arises, under the doctrine of implied powers, from its internal competence. The scope of that competence reflects the scope of its internal competence, in particular under Article 94 (ex 100) of the Treaty, which provides a general power to adopt directives approximating such rules as "directly affect the establishment or functioning of the common market".

The Community's external competence in matters of direct taxation is however shared with the Member States, which may continue to enter into agreements in so far as they do not involve the assumption of obligations which might affect Community rules or alter their scope.[35] Although as a matter of law the Community's shared external competence exists under the doctrine of implied powers even though it has not exercised its competence internally, politically it is unlikely that the Community exercise its external competence in matters of direct taxation in the absence of more far-reaching internal initiatives.

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34 Case 22/70 *Commission v Council (ERTA)* [1971] ECR 263; Case 3/76 *Kramer* [1976] ECR 1279, Opinion 1/76 [1977] ECR 741, Opinion 2/91 [1993] I-1061

35 See the judgment in *ERTA*, cited above, at paragraphs 21 and 22.

It has been argued that by virtue of the principle of Community preference Member States are obliged to grant to their fellow Member States the most favourable treatment granted in any of their world-wide treaties. The issue has yet to be tested and is perhaps more difficult than it first appears. While it seems clear that the Community is not as a matter of law required to give preference to Community nationals (see *Greece v Council*),[36] there seems to be no case law on whether an individual Member State can give privileged treatment to third country residents by comparison with residents of its Community partners. If there were a principle preventing such preferential treatment it would be necessary to determine precisely what that meant in the context of a double tax agreement (see the discussion of *Hoechst* above). Moreover, one would then have to consider whether certain privileges are justified, for example in relation to developing countries.

A further problem raised in connection with treaties between Member States and non-member countries concerns clauses limiting the benefits of treaties such as those described earlier. The problem can be illustrated by the following example: Let us suppose that Member State A enters into an agreement with a non-member country under which the benefit of a reduced withholding tax rate is granted only where the parent company of the paying subsidiary is owned, or owned substantially, by residents of a contracting State. If a company in Member State B were to exercise its right of establishment in Member State A by purchasing the parent company resident there, dividends paid by the subsidiary in the non-member country to the latter would not qualify for the reduced withholding tax rate on account of the foreign residence of the Member State B company. The latter would therefore be placed at a disadvantage by comparison with a purchaser resident in Member State A.

The above problem raises the general issue - also relevant in an intra-Community context - of the extent to which such clauses may be justified as a legitimate and proportionate means of preventing the unwarranted use of conduit companies or bases to gain treaty benefits. The proportionality issues involved here are difficult: see in that regard the discussion of the merits of different types of anti-abuse clause in the OECD working document on conduit companies. In the context of treaties with non-member countries there is the further question of whether there could be considered to be a direct breach of Article 43 (ex 52) or 56 (ex 73b) in so far as the conduct of the Member State merely consists in agreeing to different treatment by the non-member country. If not, it might be argued that Member State A could be seen to be depriving those provisions of their effectiveness by securing for its residents advantages which are denied to traders of other Member States who are established there or to companies controlled by residents of other Member States;

36 Case C-352/92 [1994] ECR I-3411.

it would therefore be in breach of the second paragraph of Article 10 (ex 5) of the Treaty, which requires Member States to "abstain from any measure which would jeopardise the attainment of the objectives of this Treaty". Alternatively, it might be argued, on the basis of the case law on external competence, that Member States' treaty-making powers had to be exercised in a manner which did not have that effect.

Outlook

Over the last few years the Commission has made it clear that its goal is co-ordination rather than harmonisation of national tax rules. The function of tax treaties as the "oil" or "valve" placed between national systems necessarily makes them an element of any co-ordinating initiative. And indeed in its Report on the Development of Tax Systems[37] the Commission identified "the role, functioning, and possible co-ordination of double taxation treaties among the subjects for discussion by the Taxation Policy Group".

Tax treaties are however merely a component of national tax law. Certainly, some issues could be considered to be specifically treaty issues and merit discussion in their own right: for example, divergent application of treaties by tax administrations and courts of Contracting Parties, the absence of any binding dispute settlement procedure, non-discrimination, triangular cases, limitation on treaty benefits and so forth. Generally, however, treaty issues can perhaps more appropriately be considered in the context of specific initiatives. For example the Savings and Interest and Royalties Directives both raise treaty issues, as does the proposed initiative concerning pensions.

The ECJ case law outlined in this article merely serves to highlight the need for discussion of treaty issues at a political level. The litigation in the ECJ has demonstrated that the existing treaty system is in certain respects unsatisfactory when viewed from the perspective of the single market. Development of the law exclusively through the judicial process is far from ideal. Case law evolves in a piecemeal and haphazard fashion, arising from disputes concerning a particular rule in a particular Member State. Not every problem will be addressed, and the complexity of the area is such that it may be difficult for the Court to chart a coherent path without the aid of any Community framework.

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37 COM(96) 546 final.

The essential difference for EC Member States by comparison with other OECD members is that they share a legal system which adopts a substantially different approach to cross-border tax issues. There must therefore be a strong case for discussion of these issues in a Community forum building on and complementing the work within the OECD.