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EC LAW AND DIRECT TAXATION — SOME THOUGHTS ON RECENT ISSUES

Paul Farmer[1]

In the last few years a number of cases have been brought before the European Court to test the compatibility of national tax provisions with the EC Treaty articles on freedom of movement. The area has also been the subject of sophisticated academic comment. The purpose of this paper is to present the author's views on some of the issues raised.

The Non-Discrimination Rule in Tax Treaty Law

In a recent article[2] an American professor, Robert Green, looking at the non-discrimination rule in international tax law, observed that the non-discrimination article in the 1981 US Model Income Tax Treaty "prohibits a host country from imposing discriminatory taxes on a business enterprise operating within its territory that is carried on, owned, or controlled by residents of the other Treaty country. The non-discrimination article does not, however, prohibit the host country from imposing discriminatory taxes on the non-resident investors in such an enterprise." Thus, although for example the US Treaty article precludes discriminatory taxation of permanent establishments of foreign enterprises or subsidiaries of a foreign corporation, it does not prevent a contracting party from "taxing non-resident investors who receive dividends, interest, royalties, or similar payments from an

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1 Paul Farmer, Legal Secretary, Court of Justice of the European Communities, Chambers of Advocate General Jacobs, L-2925, Luxembourg Tel: (+352) 430 32468 Fax: (+352) 430 32050.

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2 'The troubled rule of non-discrimination in taxing foreign direct investment', *Law and Policy in International Business*, Vol 26, No 1, p 133.

enterprise carried on [there] less favourably than it would tax resident investors receiving similar payments".

More relevantly, perhaps, the same applies to the OECD Model Convention. Under Article 24(1) of the Convention nationals 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 of a Contracting State are not "in the same circumstances"; indeed, the words "in particular with respect to residence" were added to put that matter beyond doubt. Similarly, the Commentary makes it clear that Article 24(5), which forbids a Contracting State to give less favourable treatment to an enterprise whose capital is owned or controlled by residents of the other Contracting State, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object is to ensure equal treatment for taxpayers residing in the same State, not to subject foreign capital, in the hands of partners or shareholders, to identical treatment to that applied to domestic capital.

The justification even for such a limited rule in terms of the goals of international tax law has been questioned by American analysts.[3] In EC law the question of a specific rationale for a tax non-discrimination rule has scarcely arisen.[4] The tax rule has developed as a specific instance of the general Treaty prohibition of discrimination on grounds of nationality and the rules on freedom of movement. Its rationale, and hence its scope, fall to be examined in that broader intellectual framework.

The Non-Discrimination Rule in EC Law

The Community non-discrimination rule embodied in the combined provisions of Articles 6, 48, 52, 59 and 73b of the EC Treaty covers discriminatory restrictions on the free movement of undertakings, employees, services and capital. Unlike the non-discrimination rule in tax treaties, it applies in principle not only to the

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3 Green, op cit, discusses this question in some depth. He points out that the non-discrimination rule is largely irrelevant from the viewpoint of capital export neutrality and is more closely related to capital import neutrality, perceived by many analysts to be less important. He argues, however, that the rule promotes ownership neutrality (meaning that tax rules should not interfere with market forces that result in assets being owned by the firm that can use them most productively) and is therefore desirable from the standpoint of global economic efficiency.

4 Although it may be noted that a majority of the Ruding Committee, set up by the European Commission, stressed the importance of capital import neutrality in an EC context: see p 377 of the report.

taxation of permanent establishments of foreign enterprises or subsidiaries of foreign corporations but also to the taxation of direct and portfolio investment by non-resident investors. The application of discriminatory taxation or procedures to non-resident parent companies or to individual investors may be contrary to the principle of freedom of establishment or free movement of capital. However, as will be explained below, not every disadvantage incurred by foreign investors will be considered discriminatory.

The rule prohibiting fiscal discrimination on grounds of nationality is an instance of the general Community law principle of equal treatment, which requires persons in similar situations to be treated equally (or prevents persons in different situations from being treated equally). Tax rules rarely distinguish directly on grounds of nationality; however, the principle of equal treatment also precludes indirect or covert discrimination. A Member State discriminates indirectly by its tax rules against a national of another Member State[5] *inter alia* where:

(a) the foreign national is treated differently from the national;

(b) more foreign nationals than nationals are likely to receive such treatment; and

(c) the foreign national and the national are in the same tax position **or** *substantially the same position, i.e., the differences in the situations of the foreign national and the national do not justify the different treatment.*[6]

Different treatment on grounds of residence may constitute indirect discrimination on grounds of nationality since non-residents are more likely to be non-nationals. However, many rules distinguishing on grounds of a taxpayer's residence are not discriminatory because the different treatment is attributable to the different position of the taxpayer. The equal treatment principle does not remedy double taxation arising out of conflicts of tax jurisdiction — it merely requires equal domestic tax burdens and procedures for taxpayers in similar positions. Thus, for

[5] For the purposes of the Treaty rules on freedom of establishment and the free movement of services, it is the location of a company's seat - and not the nationality or residence of its shareholders - which determines its nationality.

[6] The Treaty also protects taxpayers from discriminatory treatment by their own States insofar as they are exercising Community freedoms: see the judgment in *Daily Mail*, Case C-81/87 [1988] ECR 5483. It would seem that a similar analysis would apply: it would be necessary to consider whether the adverse treatment (e.g., a tax charge arising as a result of the exercise of the freedom) is warranted by the change in situation. See also, however, the judgment in *Werner*, Case C-112/91 [1993] ECR I-429, where the Court held that no Treaty freedom was in issue.

example, the imposition of a withholding tax on a dividend paid to a non-resident shareholder is not *per se* discriminatory. Unlike a resident he is not taxable on his dividend income, the withholding tax merely representing the exercise of partial jurisdiction by the source State. The fact that he may be subject to further taxation in his State of residence is immaterial. Similar considerations apply to the refusal of tax credits on dividend payments to non-residents under imputation systems.

However, under the EC rule, the fact that a non-resident (or a resident with foreign income) is in a different tax position is not of itself conclusive. Where taxpayers' situations are not identical, it remains necessary to ask whether the differences are material, i.e., whether there is a logical or sufficiently close connection between the differences in situations and the unfavourable treatment of the foreign national. Irrelevant differences must be disregarded.

Thus, for example, in *Commerzbank*[7] the Court held to be unlawful a United Kingdom rule denying companies that were non-resident for tax purposes repayment supplement (i.e., statutory interest) on refunds of overpaid tax. There was no logical connection between the refusal of repayment supplement to non-residents and their non-resident status.

In *Commission v France*,[8] the Court held to be contrary to Article 52 tax rules denying branches of insurance companies having their seat in other Member States the dividend tax credits granted to domestic insurers. Again, there was no sufficiently close connection between the refusal to grant dividend tax credits to the permanent establishments of non-resident insurers and their non-residence, since they were subject to tax on the dividend income received by their permanent establishments in the same way as resident insurers.

In *Biehl*[9] the Court held to be contrary to Article 48 a Luxembourg rule denying refunds of overpaid income tax to workers ceasing to be resident in Luxembourg during a tax year. A refusal of all refunds to persons entering or leaving the country during a tax year did not follow logically from their temporary residence.

The recent judgment in *Schumacker*,[10] although arousing much comment, was not revolutionary in terms of the principle of equal treatment. It is, however, a good illustration of how the principle of equal treatment in EC law differs from the non-discrimination rule in international tax law. A Belgian frontier worker employed

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7 Case C-330/91 [1993] ECR I-4017.

8 Case 270/83 [1986] ECR 273.

9 Case 175/88 *Biehl v Administration des Contributions de Luxembourg* [1990] ECR I-1779.

10 Case C-279/93, judgment of 14th February 1995.

in Germany, but resident for tax purposes in Belgium, was refused personal reliefs by the German tax authorities. The German rules reflected the principle generally recognised in international tax law that it was for the State of residence rather than the source State to provide such reliefs. The Court held, however, that, while as a general rule the source State was justified in refusing personal reliefs, in the circumstances of the case the taxpayer's non-residence did not justify the refusal of personal reliefs because the assumption that he would receive such reliefs in his State of residence was not valid.

The Public Interest Defence

The variation upon a theme[11] in which the Court has engaged has entailed importing into its narrow discrimination-based analysis in the tax sphere a public interest defence devised originally to mitigate the broad view taken of Article 30 of the Treaty in *Cassis de Dijon*.[12] Thus, the Court, having established that there is fiscal discrimination in the above sense, examines whether such discrimination may be justified on grounds not referred to in the Treaty but nevertheless recognised by Community law.

It is important to distinguish between justification of this type and justification in the sense of applying different treatment to different situations. It is only where discrimination has been established that it is necessary for a Member State to plead imperative public interest grounds in its defence. Thus, for example, it would not be discriminatory for a Member State to impose a tax charge in respect of a change of residence insofar as the charge was necessary to recover tax on, e.g., uncrystallised gains in respect of assets which would cease to fall within the State's tax jurisdiction following the change of residence. The tax charge would reflect the changing tax situation of the taxpayer. The Member State would not need to plead public interest grounds.

The public interest defence in the tax sphere was developed in the judgment in *Bachmann*,[13] where the Court held that rules which discriminated indirectly against foreign workers and insurers by refusing tax deduction of life insurance premiums and pensions contributions paid to insurers who were not established in Belgium were justified by the need to preserve the cohesion of Belgium's tax system. The supposed cohesion of the Belgian system has however been

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11 See Wouters J, 'The Case-Law of the European Court of Justice on Direct Taxes: Variations upon a Theme', *Maastricht Journal of European and Comparative Law*, Vol 1, No 2, 1994, p 179.

12 Case 120/78 *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein* [1979] ECR 649.

13 Case C-204/90 *Bachmann v Belgium* [1992] ECR I-249.

questioned by commentators.[14] In applying the cohesion test, they argue, it is necessary to look at a State's tax system as a whole, including its double taxation treaties. In ruling that Belgium was entitled to limit the deduction of pension contributions to contributions paid to insurers established in Belgium in order to be sure of being able to tax pensions paid to non-residents, the Court failed to take account of the fact that under its treaties Belgium surrendered the right to tax non-resident recipients of pensions (but had the right to tax residents on foreign source pensions regardless of whether they had been able to deduct premiums in their state of origin). Moreover, even on the Court's own logic the principle of proportionality was not applied with customary rigour. These points were taken up by Advocate General Léger in his Opinion in *Wielockx*,[15] where the Netherlands Government, relying on *Bachmann*, pleaded the need to preserve the link between deduction of pension contributions and taxation of pensions. In its recent judgment of 11th August 1995 the Court, following the Advocate General, pointed out that, having regard to the Netherlands double tax conventions, there was no strict correlation on an individual level between the deductibility of contributions and taxation of pensions; cohesion existed only at the level of the reciprocity of the rules applicable in the Contracting States.

Nevertheless, the principle of the public interest defence survives in the tax sphere, as is apparent from the judgments in *Schumacker* and *Wielockx*. It also seems that a State may rely upon it in defence of covertly discriminatory rules. It is to be hoped that in future cases the Court will scrutinise carefully such arguments, particularly where severe restrictions on freedom of movement such as those posed by residence or establishment requirements are in issue.

As a means of mitigating the broad scope of the freedoms and balancing the Community and national interests in individual cases a public interest defence based on fiscal cohesion or tax avoidance is probably unobjectionable. As we shall see, Hinnekens suggests that such a defence may be relied upon by Member States to preserve differences in the privileges offered under bilateral tax treaties.

Beyond Discrimination?

In areas other than tax, in particular in its case law on goods and services, the Court has not restricted itself to an analysis based on discrimination but has held that non-discriminatory restrictions may be contrary to the Treaty unless they are justified by imperative requirements. It might be thought there is less scope for a broader view in the tax area, since there is nothing to compare directly with the

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14 Hinnekens L and Schelpe D, (1992) *1 EC Tax Review* p 58 Knobbe-Keuk B, (1994) *3 EC Tax Review* p 74.

15 Case C-80/94, Opinion of 31st May 1995.

product regulations and other regulations of a non-discriminatory nature governing the marketing of goods and services which would have impeded the free movement of goods or services if the Court had not established the principle of mutual recognition in the absence of imperative requirements.

Nevertheless, numerous non-discriminatory disadvantages for inward or outward investment may arise from Member States' tax rules and from conflicts of tax jurisdiction. Neither the disadvantages arising under the imputation systems applied by many Member States, in particular the refusal of tax credits to foreign shareholders and the imposition of imputation taxes on foreign income, nor the levying of withholding taxes on dividend, interest or royalty payments to non-residents are per se discriminatory. They may all, however, entail disadvantages for non-residents or for residents with foreign income.

It is, however, doubtful whether such disadvantages can be resolved by a broader interpretation of the Treaty. It may be noted in that connection that Articles 73b and d(1) of the EC Treaty, inserted by the Treaty on European Union, allow the retention of tax rules which distinguish on grounds of residence of the taxpayer or place of investment provided that they do not constitute a means of arbitrary discrimination or a disguised restriction of free movement of capital and payments. In view of the confusion surrounding the interpretation of these provisions it is worth setting them out in full:

Article 73b provides:

> "(1) Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.
>
> (2) Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited."

Article 73d(1)(a) allows Member States:

> "to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested."

However, Article 73d(3) provides:

> "The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary

> discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 73b."

It is submitted that those provisions may be interpreted as confirming the Court's case law on the other freedoms. Thus, while they do not eliminate all the disadvantages for non-residents and residents with foreign income flowing from imputation systems, withholding taxes and so forth, they prohibit unjustified discrimination.[16] For example, Article 73b, in conjunction with Article 73d(1)(a), would not preclude a Member State from imposing a withholding tax on a dividend payment to a non-resident shareholder, but it would preclude it from refusing the non-resident a refund of overpaid tax — or, as in *Commerzbank*, interest on the refund — on the grounds of his non-residence.

The Member States have nevertheless agreed to a standstill on further restrictions not involving arbitrary discrimination. Declaration No 7, annexed to the Treaty on European Union, states:

> "The conference affirms that the right of Member States to apply the relevant provisions of their tax law as referred to in Article 73d(1)(a) of this Treaty will apply only with respect to the relevant provisions which exist at the end of 1993. However, this declaration shall apply only to capital movements between Member States and to payments effected between the Member States."

The basic intention of the declaration seems clear enough. Member State have undertaken not to rely on Article 73d(1)(a) to introduce new intra-Community restrictions after the end of 1993. Thus, although under the Treaty itself they may continue to apply rules which restrict inward or outward investment within the Community (providing they do not entail arbitrary discrimination), they have undertaken not to exacerbate the situation by introducing further restrictions.

It is, however, unclear what the precise status of the declaration is and what, if any, legal force it has.[17] In the view of the present commentator the Court, for its part, has rightly based its analysis in the tax area on discrimination. The more deep-seated obstacles to European integration arising from Member States' tax

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16 John Usher, referring to *Bachmann*, suggests that a discriminatory measure could be considered arbitrary if it was not justified on public interest grounds: *The Law of Money and Financial Services in the European Communities*, John A Usher, Oxford European Community Law Series.

17 Professor Toth argued that the Declarations annexed to the Single European Act did not in any way modify the legal effects of the Act and could not affect its interpretation by the European Court: (1986) CML Rev 803.

rules would be better resolved by legislative means. A broader view, in this area, entailing restrictions on a Member State's right to tax going beyond the obligation not to discriminate, would go further than the mutual recognition of regulations implicit in the Court's general tax law on goods and services.

Double Tax Treaties

External Competence in the Direct Tax Sphere

In the sphere of direct taxation it seems clear that external competence is at present shared by the Member States and the Community.

Only a limited number of Treaty provisions expressly provide for the conclusion of international agreements by the Community. However, in a series of cases[18] 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 endorsed the general 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.

The Community's competence is shared with the Member States unless some indication to the contrary arises from the text or context of the relevant Treaty provision. Hitherto the Community's exclusive competence has been recognised in relation to two provisions only: Article 113 of the Treaty on the common commercial policy and Article 102 of the Act of Accession of 1972. The significance of exclusive competence in this context is that Member States are precluded from entering into international agreements in those areas even where the Community has not acted.

The Community's external competence in the sphere of direct taxation arises, under the doctrine of implied powers, from its internal competence. There is nothing in the Treaty to suggest that such competence is exclusive. The legal basis for the Community's action in tax matters is Article 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 Article would seem to provide the basis for extensive harmonisation in the direct tax sphere. The

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18 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.

principle of parallelism demands a correspondingly broad view of the Community's external competence in direct tax matters.

For the Community to have competence in a field, it is not necessary that it should have exercised its internal competence by adopting harmonising directives — it is sufficient that such competence exists. In areas of shared or concurrent competence Member States may individually or collectively enter into international agreements (with or without the participation of the Community). However, the Court has recognised that an area of shared competence may be converted into one of exclusive competence as a result of the exercise by the Community of its internal powers:

> "Under Article 5, the Member States are required on the one hand to take all appropriate measures to ensure fulfilment of the obligations arising out of the Treaty or resulting from action taken by the institutions and, on the other hand, to abstain from any measure which might jeopardise the attainment of the objectives of the Treaty.
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> If these two provisions are read in conjunction, it follows that to the extent to which Community rules are promulgated for the attainment of the objectives of the Treaty, the Member States cannot, outside the framework of the Community institutions, assume obligations which might affect those rules or alter their scope."[19]

Thus, it seems that what exclusive competence means in this context is that, where the Community has adopted common rules, Member States may not undertake obligations which affect those rules or alter their scope. Although the position is not wholly clear, this form of exclusivity appears to differ from exclusive competence arising directly from a Treaty provision such as Article 113, inasmuch as it does not entail *a priori* exclusion of Member States from the domain but, instead, an obligation on the part of Member States not to undertake obligations which affect the rules adopted or alter their scope. It is therefore a relative concept. The extent of the exclusivity depends on the extent to which the Community exercises its internal competence in a manner which precludes the exercise of external competence by the Member States. This is particularly relevant in assessing the Member States' treaty-making competence in the direct tax area, which is likely to be one of piecemeal harmonisation.

While it seems clear, therefore, that, in the absence of extensive harmonisation, the external competence of the Member States remains largely intact, there seems

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[19] Judgment in *ERTA*, cited above, at para 21 and 22, p 275.

to be scope for future argument as to the extent to which tax treaties affect such common rules as are adopted or alter their scope.

Community Preference and the Most Favoured Nation Principle

An issue which has increasingly been discussed in tax literature is whether the EC Treaty requires a Member State to grant to other Member States most favoured nation status, i.e., the most favourable treatment which it grants under its treaties with (a) any other Member State or (b) any non-member country. In a reply to a parliamentary question the Commission took the view that there was no such requirement in the absence of common tax policies.[20] That view was supported in an illuminating article by Luc Hinnekens,[21] who argues that the principles of the most favoured nation clause (MFN) and Community preference cannot function as a surrogate for harmonisation and that multilaterality must be achieved by multilateral agreement among all the Member States rather than by "the blind and automatic application of the principle of Community preference or most favoured nation".

For sake of convenience, the proposition that Member States must accord to all Member States the privileges offered to any Member State is referred to in this paper as "Community MFN". The proposition that privileges granted by any of a Member State's tax treaties must be extended to its Community partners is referred to as "Community preference". From a legal viewpoint the case for Community preference is rather weaker than that for the application of a Community MFN principle. It is in fact unclear what legal force attaches to it. In *Greece v Council*[22] it was argued that the Council had infringed the principle by placing non-Community producers of soya beans at a competitive advantage over Community producers on the Community market. The Court replied that:

> "Whilst the principle of Community preference may be taken into account by Community institutions as an element in the common agricultural policy, it nevertheless cannot affect their decision until all the economic factors influencing world trade have been evaluated. As the Advocate General rightly observes in paragraphs 78-82 of his Opinion, Community preference is not in

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20 OJ 1993 C 40, p 13.

21 Compatibility of Bilateral Tax Treaties with European Community Law. The Rules, (1994) *EC Tax Review*, Issue 4, p 146.

22 Case C-353/92 [1994] ECR I-3411.

> any case a legal requirement the violation of which would result in the invalidity of the measure concerned."[23]

In the passage approved by the Court Advocate General Jacobs had suggested that "Community preference, although sometimes regarded as a legal requirement, is rather a matter of policy." He pointed out that the judgment in *Beus v Hauptzollant München*,[24] where the Court appeared to regard Community preference as "one of the principles of the Treaty", merely stood for the proposition that "it is not unlawful for the Community legislation, within certain limits, to give preference, as a matter of policy, to Community producers. It does not establish that the Community legislature must give such preference."

It is possible that Community preference might play a role as a policy consideration in the interpretation of the Treaty, for example where the Court was called upon to consider the compatibility of a national or Community rule with a provision of the Treaty on discrimination or free movement. In the present context, however, it seems unlikely that it would have the force, either as an independent principle or in combination with Article 5 of the Treaty, to render unlawful a supposed failure of solidarity on the part of a Member State in failing to extend the best terms offered under any of its treaties to its Community partners.

Where, on the other hand, a Member State fails to respect Community MFN by distinguishing between Member States in the grant of tax privileges, it is at least possible to present a case for a discriminatory restriction of freedom of establishment within the Community. For example, let us suppose that under its bilateral treaty with Member State B, Member State A grants a partial refund of tax credits on dividend payments made by a resident subsidiary to its parent company in Member State B, whereas it grants no refunds under its treaty with Member State C. The effect of this would be to confer on the company of Member State B, exercising its right of establishment in Member State A, an advantage over an equivalent company in Member State C. Despite the fact that both subsidiaries and both parent companies are in the same corporation tax position in Member State A (the subsidiaries being resident and taxable in that State, the parent companies non-resident and not liable to tax on their dividend income), they are subject to different treatment in respect of tax credits. A *prima facie* case for an unlawful restriction is made out, on the assumption that Article 52 covers restrictions discriminating between nationals of two other Member States, and not merely discrimination in favour of a Member State's own nationals. Since Article 52 gives specific expression to Article 6, which unequivocally

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[23] At para 50.

[24] Case 5/67 [1968] ECR 83.

prohibits all discrimination on grounds of nationality, such an assumption is perhaps not unreasonable.

In the above example, Member State A might, however, reply that the different treatment of nationals of Member States B and C does not constitute discrimination because it is attributable to their being in different positions: they are resident in different States with different tax systems and different treaties with Member State A. It might alternatively be argued, as does Hinnekens,[25] that the disparity in privileges granted, although discriminatory, is justified on public interest grounds. Member States must retain the right, through their tax treaty system, to attract foreign investment or encourage outward investment, and the generalisation of privileges would influence in an uncontrollable manner the Member States' budgetary policies (dependent on the level of withholding taxation, double tax relief) and their internal taxation policies.

The likely outcome, when the issue is eventually tested, is far from clear. The extent to which a country is willing to extend privileges under its treaties is likely, it is true, to depend on such factors as budgetary considerations, the characteristics of its tax system, its concerns in relation to inward and outward investment, foreign policy and its relative negotiating strength. However, while those considerations may explain differences in the general willingness of Member States to make concessions under their treaties, or even to make particular concessions to certain non-member countries, can they justify a disparity in the concessions granted to EC Member States? Can it be the case that in a single Community market a Member State is entitled to discriminate by its tax rules in favour of inward investment from one Member State to the detriment of inward investment from another? It is doubtful, in the light of statements made by the Court in *Commission v France*,[26] whether the extent of reciprocal privileges offered under agreements would be a satisfactory defence to discriminatory taxation. But are there other factors which are relevant? May, for example, the denial of certain benefits reflect particular concerns regarding distortions in investment decisions?

What seems clear is that, as a matter of policy, the Court is likely to approach this issue with considerable caution in view of the potentially far-reaching implications of a finding of illegality. It may moreover be expected that a taxpayer would be opposed by most, if not all, Member States; nor would he receive the support of the Commission unless the latter departs from the view expressed by Madame Scrivener in her reply to the European Parliament.

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25 'Compatibility of Bilateral Tax Treaties with European Community Law. Applications of the Rules' To be published in the (1995) *EC Tax Review*, Issue 4.

26 See footnote 8.

Limitation of Benefit Clauses

A further issue that has recently been discussed is the legality of clauses in bilateral tax treaties with non-member countries, in particular the United States, limiting treaty benefits to, essentially, residents or companies owned by residents of the contracting parties. Although they vary from agreement to agreement, such clauses are included in income tax treaties between the United States and Belgium, Denmark, Finland, France, Germany, the Netherlands, Spain, Sweden and the United Kingdom.[27] In many cases the agreements contain further clauses conferring the right to some or all benefits on certain conditions. In his recent study Martin-Jiménez[28] argues that the various clauses eliminate some but not all instances of discrimination. Let us assume that that is the case and concentrate on the basic issue of whether the EC Treaty precludes a Member State from entering into an agreement under which a non-member country applies rules which restrict a tax privilege to residents or companies owned by residents in circumstances in which such a restriction would constitute unlawful discrimination if it were applied by the Member State itself.

The problem may be illustrated by the following example. Let us suppose that Member State A enters into an agreement with the US 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 US subsidiary 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.

Some commentators appear to consider it a foregone conclusion that a Member State would be in breach of EC law by entering into such an agreement. However, such a conclusion does not follow from the existing case law; moreover, it is far from clear that the Court, given its cautious approach in this sphere, would be prepared to take such a step.

Admittedly, it is possible to formulate a plausible legal analysis. It would be difficult to establish a direct breach of Article 52 or 73b insofar as the conduct of the Member State merely consists in agreeing, by an act of public law, to discrimination by the non-member country. The argument would presumably be,

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27 For an enumeration of the clauses, see Adolfo J Martin-Jiménez's interesting article on 'EC Law and Clauses on "Limitation of Benefits" in Treaties with the US after Maastricht and the US-Netherlands Tax Treaty', (1995) *EC Tax Review*, Issue 2, p 78.

28 op cit.

however, that Member State A was to 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; it would therefore be in breach of the second paragraph of Article 5 of the Treaty, which requires Member States to "abstain from any measure which could jeopardise the attainment of the objectives of this Treaty". The bilateral tax agreement could be regarded as such a measure.

The cases to which commentators have referred do not, however, directly support such a proposition. It is true that in *Ministère Public v Asjes*[29] the Court, referring to *INNO v ATAB*,[30] held that it was contrary to the obligations of Member States under Article 5 of the EC Treaty, in conjunction with Article 3(f) and Article 85, to approve unlawfully agreed air tariffs and thus to reinforce the effects thereof. However, that case concerned the rather different issue of the **application by a Member State**, pursuant to bilateral agreements, **of national provisions** laying down a compulsory approval procedure for air tariffs. The only direct relevance to the present issue is that it demonstrates that measures adopted by a Member State may be unlawful if they undermine the effectiveness of Treaty provisions. The need to refer to Article 5 of the Treaty in that case arose from the fact that Article 85 is concerned with the conduct of undertakings, not with the rules of Member States. In the tax sphere the application by a Member State of discriminatory tax rules pursuant to a bilateral agreement would constitute a direct breach of the relevant freedom.

At first sight the judgment in *Matteucci*[31] perhaps looks more promising. The Court held that a bilateral agreement between two Member States which reserved scholarships for nationals of the two States could not prevent the application of the principle of equal treatment of workers. The Belgian authorities, against which the action had been brought, argued that to impose obligations on Belgium (the worker's host State) would be otiose insofar as the authorities of the country where training was given (Germany) were bound by the terms of the agreement. However, the Court, relying on Article 5 of the Treaty, endorsed the Italian Government's argument that Germany could not refuse to respect the choice made by Belgium where the latter had opted pursuant to Article 7 of Regulation No 1612/68 for a worker who was not a national of the host country. Again, however, the case is not on all fours with the question which concerns us here. What was at issue were unlawful acts committed by two Member States pursuant to a bilateral agreement.

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29 Case 209/84 [1986] ECR 1425.

30 Case 13/77 [1977] ECR 2115.

31 Case 235/87 [1988] ECR 5589.

Possibly the best support for such a proposition is, as already noted, to be derived from the Court's decisions on external competence, which indicate that the Member States do not have the power to enter into tax treaties which affect common rules. It might be argued that *a fortiori* they do not have the capacity to enter into agreements which undermine the effectiveness of the Treaty provisions on the freedoms.

In making its appraisal of whether a Member State was in breach of its duty of co-operation under Article 5 of the Treaty the Court might be influenced by numerous factors, such as the impact of the problem on the single market, the realities of the negotiating process, the number of agreements in issue, the implications of a finding of illegality and the existence or otherwise of warnings by the Commission. In short, the Court would have to decide, after hearing argument from the parties, the Commission and the Member States (many of which would doubtless present both written and oral argument to the Court), whether a solution could be found, or at least promoted, through the judicial process or whether it was not more appropriate for the problem to be resolved by action by the Member States at Community level.

A breach of EC law would of course only be of direct interest to practitioners if there were a remedy. Since a taxpayer would have no claim against the non-member country, the sole remedy would appear to be an action for damages against the contracting Member State. The rules governing State liability in damages for unlawful rules vary between Member States, and the principles governing liability for breaches of EC law have yet to be fully developed by the European Court. The issue has been the subject of a recent Opinion by Advocate General Léger[32] and is at present under consideration by the Court. Of particular relevance in the present context, leaving aside possible difficulties with causation and the existence of special damage, is the question whether a Member State would be liable for a breach arising from a Treaty provision about whose interpretation there was genuine doubt. The limitation of benefits issue can scarcely be considered obvious.

Conclusion

The non-discrimination rule in EC tax law is a specific instance of the general rules on freedom of movement enshrined in the EC Treaty. Although it overlaps with the non-discrimination rule in bilateral treaties, there are important differences. In particular, the process of determining whether a rule is discriminatory is conducted more rigorously. It is not sufficient in itself for a Member State to plead that a taxpayer is in a different situation with regard to

32 Case 5/94 *The Queen, ex parte Hedley Lomas (Ireland) Ltd v MAFF*, Opinion of 20th June 1995.

residence or place of investment. If it is not to be discriminatory, unfavourable treatment of a non-resident or of a resident's foreign income must follow logically from the different situation.

Applying the general rules on free movement to the tax sphere, the Court has on the whole rigorously struck down national tax provisions which discriminate against legal or natural persons of Community nationality exercising their right to free movement within the Community.

However, tax is an area in which the Member States are particularly sensitive about incursions into national sovereignty. It is also a particularly complex area in which a ruling may have far-reaching consequences going beyond the particular case. Consequently, while there are unquestionably many tax obstacles to the establishment of a single market, there are limits to what may be achieved by interpretation of the Treaty alone.

It is important to realise that not all disadvantages for non-residents or shareholders with foreign income constitute unlawful discrimination contrary to the EC Treaty. A national tax rule is discriminatory only if the non-residence of the taxpayer or the place of his investment does not justify the unfavourable treatment. The non-discrimination rule does not therefore preclude, for example, the imposition of imputation taxes on the distribution of foreign income that has not borne domestic corporation tax, the refusal to grant full double tax relief for foreign taxes paid, or the imposition of withholding taxes by which a Member State exercises jurisdiction over non-residents.

The new provisions on movements of capital in Article 73b and Article 73d are consistent with those on the other freedoms, as interpreted by the Court. Member States remain free to opt for imputation tax systems, notwithstanding their disadvantages in cross-border situations. In principle they also remain free to determine the scope of their tax jurisdiction, and in particular the extent to which they exercise jurisdiction over non-residents by means of withholding taxes. By the standstill declaration annexed to the Treaty the Member States appear to have undertaken not to introduce additional restrictions, even of a non-discriminatory nature, not existing at the end of 1993. It is however unclear what, if any, force attaches to that declaration.

While it is established, as a matter of EC law at least, that the EC Treaty takes precedence over bilateral tax treaties, it is unclear to what extent the supposed inconsistencies outlined in the literature would actually be confirmed if challenged before the European Court. While it can scarcely be disputed that action by the Community, or collectively by the Member States, to remove the obstacles to economic integration arising from bilateral treaties would be highly desirable, it is less clear that the perceived problems can be remedied through the judicial process. That is particularly true of the problems arising out of treaties between Member States and non-member countries. Even in the case of treaties between

Member States the problem of the disparities in privileges granted by Member States to their EC partners, although entailing discriminatory restrictions on cross-border establishment and investment, may ultimately be one which must be resolved by political initiatives.