GENERAL APPROACH OF THE EUROPEAN COURT OF JUSTICE AND LIMITATION OF BENEFITS CLAUSES IN DOUBLE TAX CONVENTIONS

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I. Introduction

This article illustrates the general approach of the ECJ with regard to international agreements and describes Limitation of Benefits clauses (*hereinafter LOB clause or LOB clauses*) which are contained, for instance, in the double tax conventions entered into by the US and the UK[1] and the US and Germany.[2] It then examines whether these LOB clauses are compatible with the fundamental freedoms of the EC and the State Aid provision of Art. 87(1) EC.

II. General Approach of the ECJ

It is settled case-law of the ECJ that, although direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law.[3] This basic principle does not apply only in the case of national legislation. It also applies in the case of bilateral international agreements, in particular when Member States

1 Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains of 24 July 2001 (The convention is not in force yet).

2 Convention between the Federal Republic of Germany and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income and Capital Gains of 29 August 1989.

3 Case C-270/93 *Schumacker,* para. 21; Case C-264/96 *ICI*, para. 19; Case C-446/*03 Marks & Spencer*, para. 29.

enter into double tax conventions regardless of the fact that the convention is concluded with another Member State or with a third country. This follows from the cases *St. Gobain* and *Gottardo* in which the ECJ makes it very plain that a double tax convention which is concluded with a third country must be fully compatible with the requirements of European Community law.[4]

Thus, every provision which is contained in a double tax convention entered into by a Member State must be fully compatible with the requirements of EC law. The question arises as to whether this is the case with respect to LOB clauses the compatibility of which with EC law is intensively discussed in the literature and one AG opinion has already discussed this question with regard to outbound dividends.[5]

III. Compatibility of LOB clauses with EC law

This part examines the compatibility of LOB clauses with EC law. First, it briefly describes the purpose and the content of LOB clauses. Secondly, the fundamental freedoms are applied to the requirements of LOB clauses. Thirdly, LOB clauses will also be examined under Art. 87(1) EC.

1. The purpose and content of LOB clauses

LOB clauses aim to avoid treaty shopping. Therefore they limit the benefits which are provided for in double tax conventions (in particular reduced source taxation like a lower rate of withholding tax) to persons which fulfil at least one of certain tests. According to these tests the benefits provided for in a double tax convention are granted only to persons who have a strong connection to one of the contracting States. These tests are in particular ownership, base erosion, active trade or business and stock exchange tests. These tests can be found in Art. 23 of the UK-US DTC and in Art. 28 of the Germany-US DTC.

2. The application of the fundamental freedoms to the tests

The fundamental freedoms are now applied to each of the tests. Thus, it will first be examined whether the tests impose restrictions on the fundamental freedoms and then whether possible restrictions are capable of being justified.

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4 Case C-307/97 *St. Gobain*, para. 57 – 59 and Case C-55/00 *Gottardo*, para. 32.

5 Case C-374/04 *ACT GLO IV*, Opinion of Advocate General Geelhoed, para. 97 et. seq.

a) Restrictions imposed by the tests

(i) Ownership test

The ownership test applies in particular to companies and requires that a company is more than 50% owned, directly or indirectly, by persons who are entitled to the benefits of the convention (e.g. individual residents of one of the contracting States or US citizens). Therefore a company which is validly established in the UK or in Germany but which is majority owned by residents of a State other than one of the contracting States will not qualify for the benefits of the convention and, therefore, receive a lower after withholding tax dividend for dividends distributed to it by US subsidiaries than a company which is majority owned by residents of one of the contracting States since the rate of withholding tax for the latter is lower. This leads to a cash disadvantage for companies that do not qualify for the ownership test.

This cash disadvantage is already recognised in settled case law of the ECJ as a restriction on the fundamental freedoms since it makes the exercise of the freedoms less attractive.[6] The test also enforces shareholders that want their company to qualify for the ownership test to alter the structure of the share capital to a proportion which meets the needs of the ownership test. The enforcement to alter the structure of the share capital in order to qualify for a certain scheme was already held incompatible with the freedom of establishment in the so called *"Dutch Shipping Registration case"*.[7] The Dutch legislation required that a ship could be registered in the Netherlands only if it was at least two thirds owned by one or more natural persons or companies having EU nationality. Furthermore the requirement that ownership and control of a company must be vested in a certain State in order to qualify for landing rights was held incompatible with the freedom of establishment.[8]

Thus, the ownership test imposes a restriction on the freedom of establishment.

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6 Case C-200/98 *X AB & Y AB*, para. 22; Joined Cases C-397 and 410/98 *Metallgesellschaft*, para. 44; Case C-446/03 *Marks & Spencer*, para. 32.

7 Case C-299/02 *Commission v Netherlands*, para. 19.

8 Case C-476/98 *Commission v Germany ("Open Skies")*, para. 153.

(ii) Base erosion test

The base erosion test applies cumulatively to the ownership test. It requires that not more than 50% of the gross income is used to meet liabilities to persons not entitled to the benefits of the convention. Thus, a company which uses more than 50% of its gross income to meet liabilities of a loan granted by a bank which is established in a State which has not entered into the convention will not qualify for reduced source taxation whereas a company to which the same loan was granted by a bank which is established in one of the contracting States will qualify for the benefits.

This test imposes a restriction on the free movement of capital and on the freedom to provide services. It makes the raising of capital for companies which do not qualify for it more difficult and the investment in these companies less attractive. These difficulties were already recognised by the ECJ as a restriction on the free movement of capital.[9] The test also forces the company if it wants to qualify for the LOB clause to get a loan from a creditor which is established in one of the contracting States. Therefore a different treatment exists based on the place where the creditor (the provider of services) is established. The ECJ has already held in the *Eurowings* case that a disadvantageous tax treatment based on the place where the provider of services is established imposes a restriction on the freedom to provide services.[10] Furthermore, the base erosion test limits the choice of the shareholders and the company as to whether the company should be debt rather than equity funded.

It follows that the base erosion test imposes a restriction on the free movement of capital and the freedom to provide services.

(iii) Active trade or business test

This test requires that the person who wants to qualify for the benefits is engaged in the active conduct of a business in its State of residence and the income derived from the other contracting State is derived in connection with, or is incidental, to that business or the activity in the first mentioned State is substantial in relation in the other State.

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9 Case C-319/02 *Manninen*, para. 22; Case C-35/98 *Verkooijen*, para. 34 and 35.

10 Case C-297/97 *Eurowings*, para. 40.

This test which requires the active trade or conduct of a business is against the decision of the ECJ in the *Centros* case.[11] *Centros* makes it very clear that it is possible to have a valid establishment in one Member State without being active there. This was confirmed by the decision of the ECJ in *Inspire Art* which states that the fact that a company was incorporated in a certain Member State for the sole purpose of enjoying the benefits of the legislation which seemed to be the most favourable does not constitute an abuse even if it conducts its activities entirely or mainly in the State of its secondary establishment.[12]

It follows from these decisions that the active trade or business test imposes a restriction on the freedom of establishment since it does not, contrary to the case law; allow establishing a company for the sole purpose of enjoying the benefits of a favourable regime.

(iv) Stock exchange test

The stock exchange test requires that the shares of a company which wants to qualify for the benefits of a convention are regularly traded on a recognised stock exchange which is mentioned in the double tax convention. Therefore only a company which is listed on a recognised stock exchange fulfils the test and qualifies for the benefits of the convention. A company the shares of which are listed on any other stock exchange does not fulfil the test and, accordingly, does not receive the benefits of the convention.

This test makes it even more difficult to exercise the fundamental freedoms since not every stock exchange in the Community is recognised for the purposes of the double tax convention in question. Furthermore the freedom to provide services is restricted. A company that does not fulfil one of the other tests has, in order to benefit from the convention, to be listed on one of the recognised stock exchanges. It cannot be listed on a stock exchange which is not recognised for the purposes of the convention. Therefore the choice of the available providers of services is restricted. And a stock exchange which is not recognised for the purposes of the convention can only offer its services to company on the disadvantageous condition that it is not recognised for the purposes of the convention.

Thus, the stock exchange test imposes an additional restriction on the freedom to provide services.

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11 Case C-212/97 *Centros*.

12 Case C-167/01 *Inspire Art*, para. 96

b) *Justification of the restrictions*

The next question is whether these restrictions are capable of being justified. It has to be emphasised that just one discriminatory test renders the whole LOB clause discriminatory since one discriminatory test restricts the number of available choices.[13] The LOB clause aims to avoid treaty shopping. Thus, the main reason for a possible justification is the prevention of tax avoidance which is, according to settled case law of the ECJ, a valid justification.[14]

The justification on the ground of prevention of tax avoidance requires that the national legislation at issue must have the specific purpose of preventing wholly artificial arrangements set up to circumvent the tax legislation in any Member State from attracting tax benefits.[15] The ECJ has given some guidance to this general principle. It has made clear that the setting up of a subsidiary in another Member State does not in itself constitute tax avoidance, as the subsidiary is subject to tax in its State of residence.[16] Furthermore, a Member State cannot prevent a company from setting up a subsidiary in another Member State only because it entails a reduction in tax revenue.[17]

In the field of company law the ECJ has held that the fact that a national of a Member State chooses to form a company in the Member State whose rules of company law seem to him the least restrictive cannot, in itself, constitute an abuse of the right of establishment.[18] This was confirmed in *Inspire Art*:

> *"As regards abuse of the law, it follows from Centros that the mere fact that a company does not carry on any activity in the State of formation cannot constitute such abuse. It is instead for the national authorities and courts to establish* ***in every case*** *whether the conditions on which such a restriction might be justified have been satisfied. Legislation as general as WFBV does not meet that condition."*[19]

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13 Kofler, *Tax Notes International*, 63.

14 Case C-264/96 *ICI,* para. 26; Joined Cases C-397 and 410/98 *Metallgesellschaft*, para. 57; Case C-324/00 *Lankhorst-Hohorst*, para. 37.

15 Case C-324/00 *Lankhorst-Hohorst*, para. 37.

16 Case C-264/96 *ICI,* para. 26.

17 Case C-9/02 *De Laseteyrie du Saillant*, para. 60 ; Case C-446/03 *Marks & Spencer*, para. 44.

18 Case C-212/97 *Centros*, para. 26 and 27.

19 Case C-167/01 *Inspire Art*, para. 120.

This thinking was extended to the field of direct taxation:

> *"A Community national cannot be deprived to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence."*[20]

Therefore, the mere fact that a resident of a Member State chooses to set up a company or a subsidiary in a Member State whose tax law seems to be the most favourable does not, in itself, constitute tax avoidance. The level of taxation is a factor which a company may legitimately take into account in choosing the host State for a subsidiary.[21]

The application of this legal framework to LOB clauses leads to the conclusion that LOB clauses are not capable of being justified since they do not fulfil the requirements for the prevention of tax avoidance. They are much too generally drafted and they do not contain the possibility of a case-by-case examination which could result in the denying of the benefits of a convention. The benefits are excluded for all the persons not fulfilling at least one of the aforementioned tests. The result is not changed by the entitlement of the competent authorities to grant the benefits of the convention regardless of the fulfilment of one of the tests. This entitlement does not allow denying the benefits on a case-by-case basis but grants the benefits on a case-by-case basis. It goes in the opposite direction.

The result is also not changed by the fact that the Advocate General argued in the *ACT GLO IV* case that LOB clauses are compatible with EC law. He based his opinion on the argument that Member States are entitled to make a distinction between non-residents and to determine the connecting factors for the taxation of their nationals.[22] This thinking does not apply here. The LOB contained in the double tax conventions concluded between the UK and the US and Germany and the US do not make a distinction between non-residents. They make a distinction between resident companies on the basis of the residence of the shareholders, of how the gross income is used, on whether they conduct an active trade and on whether they are publicly listed on a certain stock exchange. Furthermore the *ACT GLO IV* case concerns outbound dividends whereas the LOB clauses in question concern reduced source taxation and therefore inbound dividends.

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20 Case C-364/01 *Barbier, para. 71.*

21 Case C-196/04 *Cadburry Schweppes*, Opinion of the Advocate General Léger, para. 51.

22 Case C-374/04 *ACT GLO IV*, Opinion of Advocate General Geelhoed, para. 100 and 101.

Therefore the LOB clauses in question are not capable of being justified on ground of the prevention of tax avoidance. Other reasons for a justification like the allocation of taxing rights and coherence of the tax system are obviously not applicable here.

3. LOB clauses and State Aid

LOB clauses may also constitute prohibited State Aid within the meaning of Art. 87(1) EC. An aid must fulfil five requirements in order to constitute State Aid within the meaning of Art. 87 (1) EC:

- There must be an aid.
- It must be granted by a Member State or through State resources.
- The aid must distort or threaten to distort competition.
- It must favour certain undertakings or the production of certain goods ("selectivity principle").
- It must be capable of affecting trade between Member States.

There are some cases and arguments which strongly back the opinion that LOB clauses constitute State Aid.

a) The existence of an aid

The LOB-clause constitutes an aid. An aid comprises a benefit or an advantage for an undertaking. Tax exemptions and tax credits are clearly advantages encompassed within the State Aid definition.[23] This is also true for LOB clauses since they have the effect that they grant tax advantages for certain persons.

b) Granted by a Member State or through state resources

The aid is granted by a Member State or through state resources. The ECJ maintained that there must be a direct or indirect transfer of state resources for the article to apply.[24] This requirement is met in the instant case. The direct benefit might be conferred by the US tax authorities but, it is the Member State in question that has negotiated and entered into the double tax convention and

23 Joined Cases T-92&103/00, para. 27.

24 Case C-379/98 Preussen Electra, para. 58.

therefore has generated the possibility for the favourable tax. Furthermore double tax conventions are based on reciprocity. Thus, every benefit directly granted by the US requires a concession of the other contracting State. Therefore the benefit is granted through state resources.

c) Distorts or threatens to distort competition

An aid distorts the competition when it releases an undertaking from costs which it would normally have to bear in its day-to-day business.[25] This is the case with the lower source taxation.

d) Selectivity principle

The ECJ has held that measures applicable without distinction are not measures within the meaning of Art. 87 EC.[26] This is not the case here since the benefits are only granted to persons who meet the criteria of the LOB clauses. The selection takes place on the basis of the tests contained in the LOB clause.

e) Affecting trade between Member States

An aid affects the trade between Member State when it strengthens the position of an undertaking compared with other undertakings competing in intra Community trade.[27] This is the case here. Undertakings which meet the criteria of the LOB clauses can, due to lower source taxation, increase their resources on better conditions. Therefore their position is improved.

IV. Conclusion

One can deduce from the general approach of the ECJ and its case law in tax and non-tax cases that LOB clauses impose restrictions on the fundamental freedoms contained in the Art. 43, 48, 49 and 56 EC which are not capable of being justified. It is also arguable that they constitute State Aid within the meaning of Art. 87(1) EC.

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25 Case C-156/98, Germany v Commission, para. 30.

26 Case C-156/98, Germany v Commission, para. 22.

27 CaseC-156/98, Germany v Commission, para. 33.