Reprinted from British Tax Review Issue 1, 2018

Sweet & Maxwell
5 Canada Square
Canary Wharf
London
E14 5AQ
(Law Publishers)

To subscribe, please go to *http://www.sweetandmaxwell.co.uk/catalogue/productdetails.aspx?recordid=338&productid=6614*.

Full text articles from the British Tax Review are also available via subscription to *www.westlaw.co.uk*, or *https://www.checkpointworld.com*.

SWEET & MAXWELL

Common Consolidated Corporate Tax Base and Limitation on Benefits Clauses

Matthias Petutschnig[*]

Abstract

Based on a thorough analysis of the formulary apportionment procedure proposed by the Common Consolidated Corporate Tax Base (CCCTB) draft directive, this article evaluates the interaction between the proposed CCCTB concept and existing/future anti-treaty shopping measures, especially Limitation on Benefits (LoB) clauses. Corporate groups that are taxed according to the CCCTB concept would regularly fail the ownership and base erosion tests of standard LoB clauses. Therefore, the treaty benefits would be denied. This interplay is especially critical for the future of tax relations between the EU Member States and the US since their bilateral treaties predominately use LoBs. The findings, however, are not limited to these relations but are of worldwide interest since OECD Base Erosion and Profit Shifting (BEPS) Action 6 proposes the introduction of a LoB Clause to the OECD Model Convention. Irrespective of the substantial legal uncertainty relating to the compatibility of LoB clauses with EU law, this article shows that both the existing LoB clause as well as that proposed by BEPS Action 6 are incompatible with the CCCTB concept. The most feasible way of bringing these two layers of corporate income tax rules into accordance with each other seems to be by way of a harmonised EU-wide approach to negotiating new and renegotiating existing tax treaties with third countries conducted by the EU Commission.

1. Introduction

The current state of corporate income taxation in the EU is characterised by a vast variety of different domestic laws as direct taxes are not (thoroughly) harmonised under EU law. As a recent step towards further harmonisation, the European Commission has published a Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (the CCCTB Proposal)[1] for multinational corporate groups. The basic outline of the proposed EU-wide cross-border corporate tax system contains a consolidated group taxation. It applies formulary apportionment to allocate the consolidated taxable group income among the involved group entities. Every group member will then be taxed separately by its situs state based on the apportioned income at the situs state's statutory corporate income tax rate. Every group entity will remain liable for annual tax payments. The amount of these tax payments, however, will be determined by the overall group income and by the outcome of the apportionment procedure.

For allocation of the consolidated tax base among the involved entities and EU Member States respectively, the CCCTB Proposal includes a micro-economic factor based formula using the

[*] Assistant Professor of Accounting and Taxation, Vienna University of Economics and Business (WU), Department of Finance, Accounting and Statistics, Tax Management Group and International Research Fellow, Singapore Management University Centre for Excellence in Taxation (SMU-TA CET).

[1] European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)* (25 October 2016, COM(2016) 683 final 2016/0337 (CNS)), available at: *http://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_683_en.pdf* [Accessed 26 February 2018].

volume of Assets (A), Sales (S), Payroll cost (P) and Number of Employees (NE) at the level of the group entity in relation to the overall volume of these factors at the group level. Hence the tax base of a particular group member (Π_i) is calculated as a share of the overall CCCTB using the following formula:

$$\Pi_i = \left(\frac{1}{3}\,\frac{S^i}{S^{grp}} + \frac{1}{3} * \left(\frac{1}{2}\frac{P^i}{P^{grp}} + \frac{1}{2}\frac{NE^i}{NE^{grp}}\right) + \frac{1}{3}\frac{A^i}{A^{grp}}\right) * CCCTB$$

Figure 1: CCCTB apportionment formula

Several benefits are expected from such a group taxation, including a reduction of compliance costs, cross border loss offset and what will become the irrelevance of transfer pricing rules.[2] Sceptics, however, doubt in particular that there will be a reduction of compliance costs and expect corporate reactions, which might lead to factor shifting instead of profit shifting because formulary apportionment is in effect a tax based on “reported activity” while the current system of separate accounting is based on “reported income”.[3]

The CCCTB Proposal implies a major change in corporate income taxation from a separate entity based taxation, under which the corporate group is disregarded and every group entity is taxed as a stand-alone company, to a group-taxation that disregards the separate legal entities forming the group and taxes only profits from dealings with third parties. However, since the CCCTB Proposal regards the corporate group as one single entity only for the purposes of income determination but regards the group entities as separate taxpayers for the purposes of the mere cash flow of the corporate income taxes, this proposed paradigm shift in corporate income taxation is incomplete.[4] This incompleteness could cause several problems with the current system of international tax law which, with its myriad of bilateral tax treaties, maintains the group members (the separate legal entities) as subjects to the treaty. Establishing a new (domestic) income determination procedure, which separates income determination from income taxation while the (bilateral) tax treaty still assumes and requires an alignment of income determination

[2] EU Commission, press release, *Commission proposes major corporate tax reform for the EU* (Strasbourg: 25 October 2016, IP/16/3471), available at: *http://europa.eu/rapid/press-release_IP-16-3471_en.htm* [Accessed 9 February 2018].
[3] See E. Eberhartinger and M. Petutschnig, “CCCTB – The Employment Factor Game” (2017) 43(2) *European Journal of Law and Economics* 333; J. Martens-Weiner, “Formulary Apportionment and Group Taxation In the European Union: Insights From the United States and Canada” [2005] 8 *European Commission Taxation Papers* 1, 4; J.K. Klassen and D.A. Shackelford, “State and provincial corporate tax planning: income shifting and sales apportionment factor management” (1998) 25(3) *Journal of Accounting and Economics* 385; J. Mintz, “Europe Slowly Lurches to a Common Consolidated Corporate Tax Base: Issues at Stake” in W. Schön, et al. (eds), *A Common Consolidated Corporate Tax Base for Europe – Eine einheitliche Körperschaftsteuerbemessungsgrundlage für Europa* (Berlin/Heidelberg: Springer, 2007), 128; J. Mintz, “Corporate Tax Harmonization in Europe: It’s All About Compliance” (2004) 11(2) *International Tax and Public Finance* 221; S. Nielsen, P. Raimondos-Møller and G. Schjelderup, “Company taxation and tax spillovers: Separate accounting versus formula apportionment” (2010) 54(1) *European Economic Review*121; R.S. Avi-Yonah, “Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation” (2010) 2(1) *World Tax Journal* 3.
[4] Note that there are several other areas where the proposed paradigm shift is also incomplete, e.g. the geographical scope of the CCCTB regime especially if it is introduced as an option and not mandatorily or if only several EU Member States introduce the CCCTB regime by ways of enhanced cooperation (Treaty on the Functioning of the European Union (TFEU) Arts 326–334).

and income taxation, could cause significant frictions in the interaction between domestic tax laws and bilateral tax treaties.

This article evaluates the interaction between the proposed CCCTB concept in the CCCTB Proposal and Limitation on Benefits (LoB) clauses. This interplay is critical for the future tax relations between the EU and the US as the treaties between EU Member States and the US use this specific anti-treaty shopping measure predominately, while the remaining current tax treaty networks of EU Member States do not regularly contain LoBs. The findings of this article, are not, however, only applicable to the limited geographical scope of EU Member States and the US but are also of global application since the OECD BEPS Action Plan proposes, in its Action 6,[5] the introduction of a general LoB clause to the OECD Model Tax Convention[6] and, by way of the Multilateral Instrument (MLI),[7] LoB clauses are being introduced to numerous bilateral tax treaties.

2. CCCTB—formulary apportionment

The basic outline of the proposed CCCTB concept in the CCCTB Proposal implies that every group member separately determines its pre-consolidation income (Π_i^{PRE}). The pre-consolidation income of every involved group member will then be consolidated to form the group's overall taxable income (CCCTB). Subsequently this overall income will be apportioned to every involved group member to form its post-consolidation income (Π_i^{POST}) which finally will be taxed at the statutory tax rate of the group member's situs state. Prior literature[8] shows that Π_i^{POST} will regularly not equal Π_i^{PRE}.

In essence, the consolidation and formulary apportionment leads to a separation of income determination and income taxation. Whenever there is a loss-making company in the corporate group and the group income is positive, taxable income from the Member States of the profit-making companies is shifted by means of the formulary apportionment to the Member State of the loss-making company. This effect, however, is not limited to loss-making companies. Because of the different combinations of income-producing factors and apportionment factors,

[5] OECD/G20 Base Erosion and Profit Shifting Project, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report* (Paris: OECD Publishing, 2015).
[6] OECD, *Model Tax Convention on Income and on Capital 2008* (Paris: OECD Publishing, 2009).
[7] OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (7 June 2017).
[8] See N.D. LePan, "Comments on Musgrave" in C.E. McLure (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Taxation* (Stanford: Hoover Press, 1984), 247; C.E. McLure and J. Martens-Weiner, "Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income" in S. Cnossen (ed.), *Taxing capital Income in the European Union – Issues and Options for Reform* (Oxford: OUP, 2000), 243; J. Mintz, "Globalization of the Corporate Income Tax: The Role of Allocation" (1999) 56(3/4) *FinanzArchiv* 389; J. Martens-Weiner and J. Mintz, "An Exploration of Formula Apportionment in the European Union" (2002) 42(8) *European Taxation* 346; A. Agúndez-Garcia, "The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-Jurisdictional Corporate Income Taxation: a Review of Issues and Options" [2006] 9 *European Commission Taxation Papers* 1; J. Mintz in W. Schön, et al. (eds), above fn.3, 128; Mintz (2004), above fn.3, 221; D. Wellisch, "Taxation under Formula Apportionment – Tax Competition, Tax Incidence, and the Choice of Apportionment Factors" (2004) 60(1) *FinanzArchiv* 24; M. Petutschnig, "Sharing the Benefits of the EU's Common Consolidated Corporate Tax Base within Corporate Groups" (2015) 7(2) *World Tax Journal* 241; M. Petutschnig, *Verteilung der Besteuerungsfolgen innerhalb eines Konzerns bei Anwendung einer Common Consolidated Corporate Tax Base* (Berlin: DWS, 2012), 41 and following; Avi-Yonah, above fn.3.

this shift regularly occurs between profit-making companies also.[9] This implicit and automatic income shifting away from the entity that originally recognised the income in its pre-consolidation income calculation and also on its financial statement has ramifications for the application of bilateral tax treaties.

Assume a CCCTB group with two group members (parent company (P) and subsidiary (S)) located in different EU Member States (parent company in State A; subsidiary in State B). Subsidiary S has a foreign subsidiary (F) in a third country (X) with which State B (situs state of S) has a tax treaty but the situs state of P does not. Subsidiary S receives interest payments from F. According to the tax treaty between State B and F, the withholding tax on the interest payment is reduced to 10 per cent and credited against the income tax paid by S in State B. Since the CCCTB concept causes an automatic income shifting from State B to State A (or vice versa) it is unclear whether: 1. the tax treaty between State B and F is applicable; and/or 2. where and how much of the withholding tax paid in F can be credited against the post-consolidation income tax payments of the two group members in States A and B.

3. Limitation on Benefits clauses

Every tax treaty must establish its personal scope. It must determine who is to be treated as a resident of each Contracting State for the purpose of granting treaty benefits.[10] If a tax treaty established its personal scope and were to provide benefits to any resident of a Contracting State, it would facilitate "treaty shopping", that is, the use of legal entities established in a Contracting State by residents of third states with the purpose of obtaining the benefits of a tax treaty between the Contracting States.[11] Against this background, and deviating from the OECD Model Tax Convention,[12] the US began in the early 1980s to negotiate comprehensive LoB clauses in its tax treaties.[13] The US LoBs basically consist of a series of self-executing objective tests.[14] If a resident of one treaty partner fails to meet the LoB provision, it will not be eligible for treaty benefits; in other words, a LoB provision simply limits the personal scope of a tax treaty.[15]

[9] See further M. Petutschnig, "Common Consolidated Corporate Tax Base – Analyse der vorgeschlagenen Aufteilungsfaktoren" (2012) 89(2) *Steuer und Wirtschaft* 192; Petutschnig (2015), above fn.8; Petutschnig (2012), above fn.8, 41 and following.

[10] See G. Kofler, "European Taxation Under an 'Open Sky': LoB Clauses in Tax Treaties Between the U.S. and EU Member States" (2004) 35(27) *Tax Notes International* 45.

[11] See S.M. Haug, "The United States Policy of Stringent Anti-Treaty-Shopping Provisions: A Comparative Analysis" (1996) 29(1) *Vanderbilt Journal of Transnational Law* 191.

[12] However, although the text of the OECD Model does not contain expressed anti-abuse provisions, the commentaries contain an extensive discussion approving the use of those provisions in tax treaties to limit the ability of third-state residents to obtain treaty benefits. See, e.g. OECD, *Commentaries to the Model Tax Convention on Income and on Capital 2000*, Art.1 para.7 and following; OECD, *Commentaries to the Model Tax Convention on Income and on Capital 2003*, Art.1 para.9 and following.

[13] For a historical overview, see H.D. Rosenbloom, "Tax Treaty Abuse: Policies and Issues" (1983) 15(3) *Law and Policy in International Business* 763; W.P. Streng, "The U.S.-Netherlands Income Tax Convention — Historical Evolution of Tax Treaty Policy Issues Including Limitation On Benefits" (1991) 45(1) *Bulletin for International Taxation* 11.

[14] See, e.g. M. Rasmussen and D.D. Bernhardt, "Denmark: The 'Limitation on Benefits' Provisions in the Tax Treaty With the United States" (2001) 41(4) *European Taxation* 138.

[15] See M. Van Herksen, "Limitation on Benefits and the Competent Authority Determination" (1996) 50(1) *Bulletin for International Fiscal Documentation* 19; D. Anders, "The Limitation on Benefits Clause of the U.S.-German Tax

A typical modern LoB clause limits treaty benefits for resident corporations that fail to meet one of a number of objective tests regarding the ownership, the volume of active trade or business, or the fact of whether or not the shares are regularly traded on a (specified) stock exchange. The assumption underlying each of those tests is that a taxpayer who satisfies the requirements of any of them probably has a real business purpose for the adopted structure or has a sufficiently strong nexus to the Contracting State to warrant benefits even in the absence of a business connection, and that the business purpose or connection outweighs any purpose of obtaining the benefits of the treaty.

3.1. Evolution of the US LoB clause

The first foundations of what would later become the US standard LoB[16] provision date back to the 1945 US–UK Tax Treaty.[17] That Treaty provided for a general (15 per cent) and a special (5 per cent) withholding tax rate on dividends. In order to qualify for the special 5 per cent withholding tax rate, both an ownership test and an active business test had to be met.[18] The 1962 US–Luxembourg Treaty[19] contained the first separate anti-treaty shopping provision specifically aimed at limiting benefits under the Treaty to those persons who were citizens or residents of one of the Contracting States.[20] The 1977 US Model Income Tax Treaty[21] included a LoB article denying Treaty benefits to a company if more than 25 per cent of the company's capital was owned by non-residents and if by reason of special measures the dividend, interest, or royalty income of the company was taxed at a substantially lower rate[22] than its regular corporate profits.[23]

Treaty and Its Compatibility With European Union Law" (1997) 18(1) *Northwestern Journal of International Law & Business* 165.

[16] The term "Limitation on Benefits" was first used in the 1980 US–Jamaica Tax Treaty, signed on 21 May 1980; see further K.A. Grady, "Income Tax Treaty Shopping: An Overview of Prevention Techniques" (1983) 5(3) *Northwestern Journal of International Law & Business* 626.

[17] Convention between the United Kingdom of Great Britain and Northern Ireland and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income signed at Washington on 16 April 1945 [T.D. 5569, 1947-2 C.B. 100], see H.J. Levine and M.J. Miller, *U.S. Income Tax Treaties – The Limitation on Benefits Article* (BNA-Portfolio 936), available at: *https://www.bna.com/Treaties-Limitation-Benefits-p7753* [Accessed 9 February 2018]; I.K. Sugarman, "The U.S.-Netherlands Income Tax Treaty: Closing the Doors on the Treaty Shoppers" (1993) 17(3) *Fordham International Law Journal* 776.

[18] 1945 US–UK Tax Treaty Art.VI(1).

[19] Convention between the United States of America and the Grand Duchy of Luxembourg for the avoidance of double taxation of income, the prevention of fiscal evasion, and the promotion of trade and investment, signed at Washington on 18 December 1962 Art.XV (Holding Companies).

[20] See Levine and Miller, above fn.17; Sugarman, above fn.17; Grady, above fn.16.

[21] See Sugarman, above fn.17; see 1977 US Department of the Treasury, Model Income Tax Treaty of 17 May 1977.

[22] The requirement of a substantially reduced special tax rate rendered the LoB clause ineffective when a country's tax system imposed very low corporate tax rates in general; see Levine and Miller, above fn.17; Sugarman, above fn.17.

[23] See M.F. Huber and M.S. Blum, "Limitation on Benefits Under Article 22 of the Switzerland-U.S. Tax Treaty" (2005) 39(6) *Tax Notes International* 547.

After that, several bilateral treaties as well as the 1981 US Model Tax Treaty[24] brought some important developments. The 1978 Protocol[25] to the 1968 US–France Tax Treaty[26] introduced the so-called "derivative benefits" rule. Under this rule, treaty benefits were still granted to non-resident shareholders when similar benefits were available to them under an alternative treaty with the source country.[27] So, in a triangular case in which a French company is the parent of a US company and at the same time is also a subsidiary of a Belgian company, the French company would be granted treaty benefits even if it is used as a conduit company as long as the application of the US–France Income Tax Treaty results in the same effective taxation as the US–Belgium Tax Treaty of 27 November 2006.

The 1981 US Model Tax Treaty significantly changed the LoB clause.[28] The personal scope was extended to trusts and other entities[29] and the denial of treaty benefits was extended to all forms of income, not only passive income.[30] Most importantly, a "base erosion test" was added which denied treaty benefits if a substantial part of the income was paid to residents of a third country as interests, royalties or other deductible payments.[31] After the release of the 1981 US Model Treaty, a LoB article was included in every new US tax treaty.

The LoB clause in the 1989 US–Germany Tax Treaty[32] was the first article to represent all elements of a modern LoB clause. It was received by the literature as a major innovation[33] and has been used as a model for subsequent treaty negotiations.[34] This LoB clause provides for three

[24] United States Dept. of Treasury Model Income Tax Treaty 16 June 1981; see further L. Freitas de Moraes e Castro, "US Policy to Counter Treaty Shopping – From Aiken Industries to the Anti-Conduit Regulations: A Critical view of the Current Double-Step Approach from the Perspective of Treaty Objectives and Purposes" (2012) 66(6) *Bulletin for International Taxation* 300; R.S. Avi-Yonah and O. Halabi, "US Treaty Anti-Avoidance Rules: An Overview and Assessment" (2012) 66(4/5) *Bulletin for International Taxation* 236.

[25] 1978 Protocol to the U.S.–France Income Tax Convention Art.1(1).

[26] Convention Between the United States of America and the French Republic with Respect to Taxes on Income and Property, signed on 28 July 1967.

[27] See Levine and Miller, above fn.17.

[28] See Huber and Blum, above fn.23; Sugarman, above fn.17; Freitas de Moraes e Castro, above fn.24; Avi-Yonah and Halabi, above fn.24.

[29] United States Dept. of Treasury Model Income Tax Treaty 16 June 1981.

[30] See R.J. Rolfe and T.S. Doupnik, "The United States Attempts to Crack Down on Treaty Shopping" (1986) 38 *Tax Executive* 325; Avi-Yonah and Halabi, above fn.24; Freitas de Moraes e Castro, above fn.24.

[31] See Avi-Yonah and Halabi, above fn.24.

[32] Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, together with a Related Protocol, signed at Bonn on 29 August 1989. The Treaty with Germany was amended by several protocols—most notably the 2006 Protocol which broadened the scope of the LoB clause, see further P.H. Dehnen, "2006 Amendments to the Germany-United States Tax Treaty Become Effective" (2008) 62(7) *Bulletin for International Taxation* 265.

[33] See Levine and Miller, above fn.17; D.M. Berman and J.L. Hynes, "Limitation on Benefits Clauses in U.S. Income Tax Treaties" (2000) 29(12) *Tax Management International Journal* 692.

[34] The United States concluded in the years between 1989 and 1994 new tax treaties with Finland (signed on 21 September 1989), Spain (signed on 22 February 1990), Russia (signed on 17 June 1992), Czech Republic (signed on 16 September 1993), Slovak Republic (signed on 8 October 1993), Kazakhstan (signed on 19 October 1993), Ukraine (signed on 4 March 1994), Sweden (signed on 1 September 1994) and Portugal (signed on 6 September 1994). With minor exceptions, the LoB provisions included in these treaties mirror the one included in the 1989 US–Germany Tax Treaty. The 1992 US–Netherlands Tax Treaty and subsequently the 1994 US–France Tax Treaty (signed on 31 August 1994) though contain much more detailed and more complex wording, which was first insisted on by the Netherlands who were concerned that the text of the 1989 US–Germany Tax Treaty was too general. See Sugarman, above fn.17. For further discussion of the LoB provision in the 1992 US–Netherlands Tax Treaty, see P.T. Kaplan,

alternative methods for qualifying for treaty benefits. First, under the so-called "automatic qualification", four types of persons (individuals, the US or German Government, public companies and non-profit organisations). Additionally, all persons satisfying an ownership test (50 per cent domestic ownership) and a base erosion test, were eligible for Treaty benefits.[35] The second alternative was the so-called "Active Business Connection Test" under which, in order for a person to be entitled to Treaty benefits, they must be engaged in the active conduct of a trade or business in the residence state and the income derived from the other state has to be connected to that trade or business.[36] As a third alternative, the provision contains a "safety-valve" under which both countries are allowed to grant Treaty benefits on a discretionary basis.[37]

The subsequent US Model Tax Treaties (1996,[38] 2006,[39] 2016[40]) are characterised by a back and forth of adding and subtracting several aspects of the LoB clause. The 1996 US Model Tax Treaty's LoB clause resembled in large part the LoB clause in the 1989 US–Germany Treaty, however it repealed the Principal Purpose Test of the 1981 US Model Tax Treaty. Article 22 of the 2006 US Model Tax Treaty reduced the list of types of persons that were entitled to Treaty benefits with no restrictions (individuals, publicly traded companies, governments, political subdivisions and local authorities of a Contracting State).[41] Further, the safe harbour rule for substantial trade or business was removed.[42] The 2006 US Model Tax Treaty did not include a derivative benefits rule for triangular arrangements anymore.[43] However, the subsequently agreed treaties and protocols with Bulgaria,[44] Malta,[45] New Zealand[46] and France[47] all provide for a

"Treaty Shopping Under the New U.S.-Netherlands Treaty" (1993) 47(4) *Bulletin for International Fiscal Documentation* 175.

[35] See Levine and Miller, above fn.17.

[36] See Levine and Miller, above fn.17.

[37] See Levine and Miller, above fn.17; see further Memorandum of Understanding to the 1989 US–Germany Tax Treaty, Ex. VII.

[38] The tax treaties concluded with Estonia (signed on 15 January 1998), Latvia (signed on 15 January 1998), Lithuania (signed on 15 January 1998), Slovenia (signed on 22 June 2001) and Italy (signed on 25 August 1999—see further P. Valente and M. Magenta, "Analysis of Certain Anti-Abuse Clauses in the Tax Treaties Concluded by Italy" (2000) 54(1) *Bulletin for International Taxation* 41) included LoBs all of which followed for the most part the 1996 US Model Treaty. See further Freitas de Moraes e Castro, above fn.24; Avi-Yonah and Halabi, above fn.24.

[39] See further Avi-Yonah and Halabi, above fn.24; Freitas de Moraes e Castro, above fn.24.

[40] United States Model Income Tax Convention, available at: *https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf* [Accessed 9 February 2018]; see further R. Julien, P. Koch and R. Szudocky, "What Has Changed in the Limitation on Benefits Clause of the 2016 US Model?: Technical Modifications, Policy Considerations and Comparisons with Base Erosion and Profit Shifting Action 6" (2017) 45(1) *Intertax* 12.

[41] Avi-Yonah and Halabi, above fn.24.

[42] R.S. Avi-Yonah and M.B. Tittle, "The United States Model Income Tax Convention" (2007) 61(6) *Bulletin for International Taxation* 224; Avi-Yonah and Halabi, above fn.24.

[43] See Freitas de Moraes e Castro, above fn.24.

[44] Convention between the Government of the United States of America and the Government of the Republic of Bulgaria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (signed on 23 February 2007).

[45] Convention between the Government of the United States of America and the Government of Malta for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (signed on 8 August 2008).

[46] Protocol between the United States of America and New Zealand signed on 1 December 2008 Amending the Convention and Protocol between the United States of America and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income signed on 23 July 1982.

[47] Protocol Amending the Convention between the Government of The United States of America and the Government of The French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to

derivative benefits rule. The 2016 US Model Tax Treaty's[48] LoB clause (Article 22) reintroduces the derivative benefits test[49] but subjects it to a base erosion test, which denies the benefits if at least 50 per cent of the gross income of the particular company is paid or accrued in the form of deductible payments to non-treaty residents.[50]

3.2. A typical modern LoB clause

The historical evolution described in section 3.1, above, shows some communalities of existing LoB clauses which all LoB clauses (or at least the vast majority of them) contain:

- a list of *automatically qualifying types of persons*—usually: individuals, publicly traded companies, governments, political subdivisions and local authorities of a Contracting State; sometimes: non-profit organisations and pension funds;
- an *ownership test*—satisfied when a certain percentage (usually at least 50 per cent) of the shares are owned, directly or indirectly, by qualified persons themselves;
- a *base erosion test*—satisfied when only insignificant parts (usually less than 50 per cent) of the income is paid or accrued to non-qualified persons (non-residents);
- a *derivative benefits clause* for triangular cases.

Even though the US is almost the sole state to negotiate LoB clauses regularly in its tax treaties, the most recent and for the time being final development of LoB clauses came from the OECD. Action 6 of the OECD BEPS Action Plan contains a LoB clause (Article X) which was added as (new) Article 29 "Entitlement to Benefits" to the OECD Model Convention (MC) by the 2017 update.[51]

BEPS Action 6—Article X contains all of the major aspects of a modern LoB clause as mentioned above. The fundamental aim of Article 29 OECD MC is to only grant treaty protection to taxpayers that, in addition to being residents, either carry out real business activities, have a sufficient nexus to their residence state or have bona fide motives. Article 29 OECD MC (or Article X respectively) contains many of the specifics of the various US LoBs but also deviates from the US "blueprint" in certain aspects. The list of types of persons that automatically qualify for treaty benefits (individuals, publicly traded companies, governments, political subdivisions and local authorities of a Contracting State, non-profit organisations and pension funds) is slightly broader than that of the 2006 US Model Tax Treaty.[52]

Taxes on Income and Capital, signed on 31 August 1994, as amended by the Protocol signed on 8 December 2004 (signed on 13 January 2009); see further G. Galinier-Warrain, "New Protocol to the France-United States Tax Treaty" (2009) 63(5) *Bulletin For International Taxation* 216.

[48] US Model Income Tax Convention Art.22, available at: *https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf* [Accessed 9 February 2018]. See further Julien, Koch and Szudocky, above fn.40.

[49] Previous tax treaties (e.g. US–Germany of 1989, US–UK of 2001, US–Poland of 2013) contained similar provisions, which however limited the scope of admissible third countries to EU/EEA Member States or parties to the North American Free Trade Agreement (NAFTA); see further Julien, Koch and Szudocky, above fn.40.

[50] See further Julien, Koch and Szudocky, above fn.40.

[51] OECD, *The 2017 update to the OECD Model Tax Convention* (2017), available at: *http://www.oecd.org/ctp/treaties/2017-update-model-tax-convention.pdf* [Accessed 26 February 2018].

[52] See J. Bates, et al., "Limitation on Benefits Articles in Income Tax Treaties: The Current State of Play" (2013) 41(6/7) *Intertax* 395; A. Wardzynski, "The Limitation on Benefits Article in the OECD Model: Closing Abusive

The most important part of Article 29 OECD MC for the purposes of this article is the ownership and base erosion test as well as the derivative benefits clause. The two tests ensure that a majority of the equity owners (assessed by the ownership test) and non-equity holders (evaluated by the base erosion test) are residents of one of the Contracting States.[53] The ownership test requires that at least 50 per cent of each class of shares are owned, directly or indirectly, by qualified persons themselves. The base erosion test is satisfied when less than 50 per cent of the company's taxable gross income is paid or accrued to non-qualified persons (non-residents). The derivative benefits clause allows certain entities owned by residents of third states to obtain treaty benefits if these residents are "equivalent beneficiaries" who would have been entitled to equivalent benefits if they had invested directly in the source state.[54] The derivative benefits clause contains again an ownership and base erosion test. Whereas the base erosion test is identical to the one referred to above,[55] the ownership test is fulfilled if seven or fewer beneficiaries own (directly or indirectly) at least 95 per cent of the shares.[56]

3.3. Limitation on Benefits clauses in tax treaties between EU Member States and the US

The first LoB provision in a treaty between the US and a (now) EU Member State is found in the Treaty with Cyprus (1984).[57] Since then (almost) every negotiated or amended tax treaty with an EU member contains a comprehensive LoB clause with ever-increasing complexity and detail. Out of the current 28 EU Member States, 27 have an applicable tax treaty with the US; Croatia is the only EU Member State that does not have a tax treaty with the US, however the two countries are currently in negotiations to conclude a tax treaty. Out of the 27 tax treaties between the US and EU Member States four treaties do not contain a LoB clause and 23 treaties do contain such a provision. The US treaties with Greece, Hungary,[58] Poland and Romania are rather old treaties and date back to a period when the US had not yet started to conclude comprehensive LoB clauses in its treaties: the Treaty with Greece in 1950, with Hungary in 1979, with Poland in 1974 and with Romania in 1973. The Treaty with Italy does not contain a LoB clause in the text of the Treaty however such a provision is incorporated into the Protocol to the Treaty. See Table 1 for an overview of the tax treaties between EU Member States and the US.

(Undesired) Conduit Gateways" (2014) 68(9) *Bulletin for International Taxation* 471; S. Kolundzija, "OECD Minimum Standard: Comparing LOB and PPT" in D. Blum and M. Seiler (eds), *Preventing Treaty Abuse* (Vienna: Linde, 2016), 355; L. De Broe and J. Luts, "BEPS Action 6: Tax Treaty Abuse" (2015) 43(2) *Intertax* 122; R. Szudoczky and P. Koch, "Limitation on Benefits: 'Qualified Person' – Article X (1) and (2) of the OECD Model" in M. Lang, et al. (eds), *Base Erosion and Profit Shifting (BEPS)* (Vienna: Linde, 2016), 227; D. Dominguez, "Limitation on Benefits: Comparison between the US LOB and the OECD LOB proposed under Action 6" in Blum and Seiler (eds), above, 305.

[53] See BEPS Action 6, above fn.5, Art.X(2)(e).

[54] See Kolundzija, above fn.52, 357 and following; M.A.C. Camayo, "Limitation on Benefits: Derivative Benefits and Discretionary Relief" in Blum and Seiler (eds), above fn.52, 233 and following; Wardzynski, above fn.52.

[55] For further details, see Camayo, above fn.54, 242 and following.

[56] BEPS Action 6, above fn.5, Section A, para.59 and following; see further Camayo, above fn.54, 239 and following.

[57] Cyprus–United States DTC, signed 19 March 1984 Art.26.

[58] A new tax treaty between the US and Hungary has already been negotiated and signed in 2010. However it has not yet been ratified by both treaty partners; see T. Tuerff, et al., "US Tax Scene" (2010) 38(5) *Intertax* 325.

Table 1: Tax Treaties, US–EU Member States

No	Country	Year	LoB	Ownership test/threshold	Base erosion test	Derivative benefits
1	Austria	1996	Art.16	YES/50%	YES	YES (Competent Authority Agreement)
2	Belgium	2006	Art.21	YES/50%	YES	No
3	Bulgaria	2007	Art.21	YES/50%	YES	YES
4	Croatia	n/a	n/a	n/a	n/a	n/a
5	Cyprus	1984	Art.26	YES/75%	YES	No
6	Czech Republic	1993	Art.17	YES/50%	YES	YES (Competent Authority Agreement)
7	Denmark	1999	Art.22	YES/50%	YES	YES
8	Estonia	1998	Art.22	YES/50%	YES	YES (Competent Authority Agreement)
9	Finland	1989	Art.16	YES/50%	YES	YES (Competent Authority Agreement)
10	France	1994	Art.30	YES/50%	YES	YES
11	Germany	1990	Art.28	YES/50%	YES	YES (Competent Authority Agreement)
12	Greece	1950	n/a	n/a	n/a	n/a
13	Hungary	1979	n/a	n/a	n/a	n/a
14	Ireland	1997	Art.23	YES/50%	YES	YES
15	Italy	1999	Art.2 Protocol	YES/50%	YES	YES (Competent Authority Agreement)
16	Latvia	1998	Art.23	YES/50%	YES	YES (Competent Authority Agreement)
17	Lithuania	1998	Art.23	YES/50%	YES	YES (Competent Authority Agreement)
18	Luxembourg	1996	Art.24	YES/50%	YES	YES
19	Malta	2008	Art.22	YES/75%	YES	YES
20	Netherlands	1992	Art.26	YES/50%	YES	YES
21	Poland	1974	n/a	n/a	n/a	n/a
22	Portugal	1994	Art.17	YES/50%	YES	YES (Competent Authority Agreement)
23	Romania	1973	n/a	n/a	n/a	n/a
24	Slovakia	1993	Art.17	YES/50%	YES	YES (Competent Authority Agreement)
25	Slovenia	1999	Art.22	YES/50%	YES	YES (Competent Authority Agreement)
26	Spain	1990	Art.17	YES/50%	YES	YES (Competent Authority Agreement)

No	Country	Year	LoB	Ownership test/threshold	Base erosion test	Derivative benefits
27	Sweden	1994	Art.17	YES/50%	YES	YES (Competent Authority Agreement)
28	United Kingdom	2001	Art.23	YES/50%	YES	YES
	OECD BEPS Action Plan		Art.X	YES/50%	YES	YES

4. CCCTB and Limitation on Benefits clauses

4.1. The interplay between the CCCTB concept and LoB clauses

As addressed above, the proposed CCCTB concept in the CCCTB Proposal leads systematically to a divergence of income determination and income taxation. The formulary apportionment mechanism allocates taxable income to every separate legal entity that forms part of the corporate group irrespectively of where that allocated share of income was originally recognised (as part of Π_i^{PRE}). With regard to LoB clauses the automatic transfer of taxable income from one separate legal entity to another through the apportionment formula might infringe the base erosion test as it is agreed upon in the vast majority of the tax treaties between the US and EU Member States and as it is stipulated in (the new) Article 29 of the OECD MC. Failing the base erosion test initiates the legal consequences of the LoB clause, renders the respective tax treaty inapplicable and leads to a potential double taxation of US source income as the US withholding tax is not reduced by the treaty.

4.2. Infringement of fundamental freedoms

Several authors have discussed and questioned whether LoB clauses in tax treaties between the US and EU Member States might infringe the fundamental freedoms of the EU Treaty (Treaty on the Functioning of the European Union (TFEU)).[59] However, none of these studies has ever

[59] See, e.g. Kofler, above fn.10; O. Thömmes, "U.S.-German tax treaty under examination by the EC Commission" (1990) 18(12) *Intertax* 605; L. Hinnekens, "Compatibility of Bilateral Tax Treaties with European Community Law – The Rules" (1994) 3(4) *EC Tax Review* 146; A.J. Martín-Jiménez, "EC Law and Clauses on 'Limitation of Benefits' in Treaties With the U.S. After Maastricht and the U.S.-Netherlands Tax Treaty" (1995) 4(2) *EC Tax Review* 78; L. Hinnekens, "Compatibility of Bilateral Tax Treaties with European Community Law – Application of the Rules" (1995) 4(4) *EC Tax Review* 202; P. Farmer, "EC Law and Direct Taxation – Some Thoughts on Recent Issues" (1995) 1(2.1) *EC Tax Journal* 91; T.A. Kaye, "European Tax Harmonization and the Implications for U.S. Tax Policy" (1996) 19(1) *Boston College International and Comparative Law Review* 109, 164 and following; Anders, above fn.15; G. Toifl, "Austria" in P. Essers, G. de Bont and E. Kemmeren (eds), *The Compatibility of Anti-Abuse Provisions in Tax Treaties With EC Law* (Alphen aan den Rijn: Kluwer Law International, 1998), 49 and following; E. Kemmeren, "The Netherlands" in Essers, de Bont and Kemmeren (eds), above, 146 and following; see also, M.C. Bennett, et al., "A Commentary to the United States-Netherlands Tax Convention" (1993) 21(4/5) *Intertax* 165; M. Dahlberg, "New Tax Treaty Between Sweden and the U.S. Raises Questions About Treaty-Shopping" (1997) 25(8/9) *Intertax* 295; F. Debelva, et al., "LOB Clauses and EU-Law Compatibility: A Debate Revived by BEPS?" (2015) 24(3) *EC Tax Review* 132; R. Mason, "U.S. Tax Treaty Policy and the European Court of Justice" (2005) 59 *N.Y.U. Tax Law Review* 65; B. Clark, "The Limitation on Benefits Clause Under an Open Sky" (2003) 57(1) *European Taxation* 22; E. Kemmeren, "Where is EU Law in the OECD BEPS Discussion?" (2014) 23(4) *EC Tax Review* 190; J. Calejo Guerra, "Limitation on Benefits Clauses and EU Law" (2011) 51(2/3) *European Taxation* 85; Bates, et al., above fn.52; A.P. Dourado, "Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendations on Aggressive Tax

addressed the specifics of the "build-in" base erosion of the proposed CCCTB concept in the CCCTB Proposal and its interplay with LoB clauses. It may be seen as an unjustified interference with the freedom of establishment or the free movement of capital if companies whose shareholders are residents of other EU Member States would not qualify under a specific LoB clause in a treaty between the US and an EU Member State. However, as EU law cannot create obligations for third countries it is not straightforward that the source of this interference lies in the mere entering into that type of treaty by the respective Member State.[60]

Since the TFEU does not provide for a comprehensive harmonisation of direct taxes the Member States retain their competences in direct tax matters.[61] EU Member States, however, must exercise these competences consistently with EU law. Therefore, they have to avoid any overt or covert discrimination on grounds of nationality. In general, such discrimination arises through the application of different rules to similar (comparable) situations or through the application of the same rules to different situations.[62]

It is well established by the Court of Justice of the European Union (CJEU) that national tax laws have to adhere to the four freedoms of the TFEU (Article 45 TFEU ("freedom of movement for workers"), Articles 49 and 54 TFEU ("freedom of establishment"), Article 56 TFEU ("freedom to provide services"), and Article 63 TFEU ("free movement of capital")) and the principle of equal treatment (Article 18 TFEU "…discrimination on grounds of nationality shall be prohibited"). Each of the fundamental freedoms is directly applicable in the Member States and takes precedence over any domestic legislation.[63] Undoubtedly, the fundamental freedoms of the TFEU apply also to provisions in tax treaties,[64] and EU law prevails over bilateral treaties by virtue of hierarchy (*lex superior derogat de lege inferiori*).[65]

Planning and BEPS Actions 2 and 6" (2015) 43(1) *Intertax* 42; E. Osterweil, "Are LOB Provisions in Double Tax Conventions Contrary to EC Treaty Freedoms?" (2009) 18(5) *EC Tax Review* 236; P. Plansky and H. Schneeweiss, "Limitation on Benefits: From the US Model 2006 to the ACT Group Litigation" (2007) 35(8/9) *Intertax* 484.

[60] See D. Van Unnik and M. Boudesteijn,"The New US-Dutch Treaty and the Treaty of Rome" (1993) 2(2) *EC Tax Review* 106; Martín-Jiménez, above fn.59; Farmer, above fn.59; M. Tumpel,"Europarechtliche Besteuerungsmaßstäbe für die grenzüberschreitende Organisation und Finanzierung von Unternehmen" in J. Pelka (ed.), *Europa- und verfassungsrechtliche Grenzen der Unternehmensbesteuerung DStJG 23* (Köln: O. Schmidt, 2000), 321–365; Kofler, above fn.10.

[61] Harmonisation in the field of direct taxation is still limited to some directives, see, e.g. B. Terra and P. Wattel, *European Tax Law*, 6th edn (Alphen aan den Rijn: Kluwer Law International, 2012), 335 and following.

[62] See further Kofler, above fn.10; A. Cordewener, *Europäische Grundfreiheiten und nationales Steuerrecht* (Köln: O. Schmidt, 2002); G. Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht* (Vienna: Linde, 2007).

[63] Kofler, above fn.10, 57.

[64] See, e.g. Kofler, above fn.10, 57; M. Lang, "Die Bindung der Doppelbesteuerungsabkommen an die Grundfreiheiten des EU-Rechts" in W. Gassner, M. Lang and E. Lechner (eds), *Doppelbesteuerungsabkommen und EU-Recht* (Vienna: Linde, 1996), 27 and following; P. Pistone, *The Impact of Community Law on Tax Treaties* (Alphen aan den Rijn: Kluwer Law International, 2002), 11 and following; A. Randelzhofer and U. Forsthoff, "Freiheiten und direkte Steuern" in E. Grabitz and M. Hilf (eds), *Das Recht der Europäischen Union* (München: C.H. Beck, 2003), Vor Art.39–55 para.256 and following. See also *Commission of the European Communities v French Republic ("avoir fiscal")* (270/83) [1986] ECR 285 at [26]; *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt* (*Compagnie de Saint-Gobain*) (C-307/97) [1999] ECR I-6161 at [58].

[65] See Kofler, above fn.10, 57; Pistone, above fn.64, 84; Hinnekens (1994), above fn.59; see also *Commission of the European Economic Community v Italian Republic* (10/61) [1962] ECR 1.

The non-discrimination principle of the TFEU[66] applies in general by reference to nationality. With respect to companies, their corporate seat determines their connection to a Member State's legal order without regard to the actual residence of their shareholders. A difference in tax treatment based on the place of incorporation may therefore amount to an overt discrimination.[67] Furthermore, the CJEU has made clear that the rules regarding equal treatment forbid not only overt discrimination but also covert forms of discrimination, which, by the application of other criteria of differentiation, lead to the same result.[68] This is especially important for tax rules, since none of the Member States impose their taxing rights by reference to the nationality of the taxpayers but operates with the concept of residence.[69]

Because the fundamental freedoms of the TFEU also apply to tax treaties, LoB clauses need to be scrutinised with respect to their compatibility with the EU freedoms. Problematic from a fundamental freedoms' perspective is the fact that LoB clauses give rise to a difference in treatment between two types of residents, that is, qualifying and non-qualifying residents. The different treatment is primarily caused by the stock-exchange test,[70] the ownership and base erosion test and in some cases specific ownership tests for specific investment vehicles such as pension funds and investment funds.[71] All of these requirements have been described in the literature as, prima facie at least, potentially infringing the fundamental freedoms.[72] Thus, two aspects of existing/proposed LoB clauses demand specific attention: 1. the ownership and base erosion test as this is the main criterion used to deny treaty benefits; and 2. the derivative benefits clause as this might safeguard treaty benefits.

4.2.1. Ownership test and base erosion test

The ownership clause typically denies treaty benefits if at least 50 per cent of the shareholders of the company are not residents of either of the two Contracting States. It thus precludes benefits

[66] TFEU Art.18 states, "any discrimination on grounds of nationality shall be prohibited".
[67] See Kofler, above fn.10, 58; see further *Centros Ltd v Erhvervs- og Selskabsstyrelsen* (*Centros*) (C-212/97) [1999] ECR I-1459.
[68] See *R. v IRC Ex p. Commerzbank AG* (C-330/91) [1993] ECR I-4017 at [14]; *Halliburton Services BV v Staatssecretaris van Financiën* (C-1/93) [1994] ECR I-1137 (at [15]); *Finanzamt Köln-Altstadt v Roland Schumacker* (*Finanzamt Köln-Altstadt*) (C-279/93) [1995] ECR I-225 at [26]; *Société Baxter and Others v Premier Ministre and Others* (C-254/97) [1999] ECR I-4809 at [10]; *Patrick Zurstrassen v Administration des Contributions Directes* (C-87/99) [2000] ECR I-3337 at [18]; *Federal Republic of Germany v Commission of the European Communities* (C-156/98) [2000] ECR I-6857 at [83]; *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna* (C-294/97) [1999] ECR I-7447 at [33]; *Centros* (C-212/97), above fn.67 [1999] ECR I-1459 at [39].
[69] See B. Knobbe-Keuk, "Restrictions on the Fundamental Freedoms Enshrined in the EC Treaty by Discriminatory Tax Provisions – Ban and Justification" (1994) 3 *EC Tax Review* 74; M. Gammie and G. Brannan, "EC Law Strikes at the UK Corporation Tax – The Death Knell of UK Imputation?" (1995) 23(8/9) *Intertax* 389; M. Jann, "Die Auswirkungen des EU-Rechts auf die Abkommensberechtigung von beschränkt Steuerpflichtigen" in Gassner, Lang and Lechner (eds), above fn.64, 57.
[70] The stock-exchange test is restrictive as it excludes private limited companies, which restricts investors from choosing the legal form which best suits their needs. Additionally companies must usually list their shares on a specific stock exchange agreed upon by the treaty partners. This is at least prima facie contrary to the freedom of establishment (see Bates, et al., above fn.52).
[71] This difference in treatment can be mitigated by the various bona fide subclauses such as the active trade or business test and the derivative benefits test.
[72] See among others Kofler, above fn.10, 59; R. Lyal, "Non-discrimination and direct tax in Community law" (2003) 12(2) *EC Tax Review* 68; P. Farmer, "The Court's case law on taxation: a castle built on shifting sands?" (2003) 12(2) *EC Tax Review* 75; Debelva, et al., above fn.59; Mason, above fn.59.

for corporations whose shareholders are residents of other EU Member States. A company qualifies for the CCCTB regime if the parent has a right to exercise more than 50 per cent of the voting rights.[73] As the CCCTB concept is designed for groups of companies that are internationally active within the EU, the parent company will regularly be located in an EU Member State which is different from that of the subsidiary. Thus, a company, which is part of a CCCTB group will regularly fail this test.

The base erosion test is satisfied when less than usually 50 per cent of the company's gross income for the taxable period is paid or accrued to non-qualified persons and is thus not taxed in the situs state of the company. The formulary apportionment of the proposed CCCTB concept in the CCCTB Proposal leads regularly to a divergence between the place where the income is recognised and collected on the one hand and the place where (at least parts of) that income is taxed on the other hand. Whether or not the base erosion test is met will depend on the individual result of the apportionment formula of the CCCTB group as discussed above. The base erosion test complements the ownership test but has, with respect to CCCTB groups, only limited effects. Since the CCCTB group subsidiaries will regularly fail the ownership test, the base erosion test applies mainly to the CCCTB parent. This might constitute a covert discrimination.[74]

While the question of a specific LoB's compatibility with EU law has never been directly discussed by the CJEU, two CJEU decisions are of specific interest and importance for this issue: 1. the *Open Skies* judgments[75] that dealt with bilateral (non-tax) treaties between EU Member States and the US with respect to airline transportation rights; and 2. the *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue* (*ACT Group Litigation*)[76] ruling that dealt with bilateral anti-treaty shopping rules but did not specifically focus on LoB clauses.

The CJEU ruled in the *Open Skies* judgments[77] that Member States must comply with EU law when concluding international treaties. The *Open Skies* agreements contained so-called "nationality clauses" by which a Contracting State granted the benefits of that agreement to an airline that was controlled by nationals of Contracting States while it denied those benefits to an airline that was controlled by nationals of non-Contracting States. The CJEU considered the situation of resident airlines owned by nationals to be comparable to resident airlines owned by

[73] See CCCTB draft directive (COM(2016) 683 and COM(2016) 685) Art.3.
[74] See Kofler, above fn.10, 63; Clark, above fn.59.
[75] *Commission of the European Communities v United Kingdom of Great Britain and Northern Ireland* (*Commission v UK*) (C-466/98) [2002] ECR I-9427; *Commission of the European Communities v Kingdom of Denmark* (*Commission v Denmark*) (C-467/98) [2002] ECR I-9519; *Commission of the European Communities v Kingdom of Sweden* (*Commission v Sweden*) (C-468/98) [2002] ECR I-9575; *Commission of the European Communities v Kingdom of Belgium* (*Commission v Belgium*) (C-471/98) [2002] ECR I-9681; *Commission of the European Communities v Grand Duchy of Luxembourg* (*Commission v Luxembourg*) (C-472/98) [2002] ECR I-9741; *Commission of the European Communities v Republic of Austria* (*Commission v Austria*) (C-475/98) [2002] ECR I-9797; *Commission of the European Communities v Federal Republic of Germany* (*Commission v Germany*) (C-476/98) [2002] ECR I-9855.
[76] *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue* (C-374/04) [2006] ECR I-11673.
[77] *Commission v UK* (C-466/98), above fn.75, [2002] ECR I-9427; *Commission v Denmark* (C-467/98), above fn.75, [2002] ECR I-9519; *Commission v Sweden* (C-468/98), above fn.75, [2002] ECR I-9575; *Commission v Belgium* (C-471/98), above fn.75, [2002] ECR I-9681; *Commission v Luxembourg* (C-472/98), above fn.75, [2002] ECR I-9741; *Commission v Austria* (C-475/98), above fn.75, [2002] ECR I-9797; *Commission v Germany* (C-476/98), above fn.75, [2002] ECR I-9855.

non-nationals. Therefore, the different treatment resulted in a prohibited discrimination. The unwillingness of the third state to (re-)negotiate cannot justify a discrimination, and the source of a discrimination lies in the mere entering into such a treaty. According to the *Open Skies* decisions it is not relevant which treaty partner applies the infringing clause. It is only relevant that its application produces discriminatory effects for residents of other EU Member States. Once the covert discrimination is identified, it can be justified only if the provision in question pursues a legitimate aim compatible with the TFEU, is justified by pressing reasons of public interest, is able to achieve its aims and does not go beyond what is necessary for that purpose.[78]

The literature derived from the *Open Skies* rulings that, because of the parallels between the bilateral air transportation treaties and the bilateral tax treaties, the *Open Skies* judgments were transposable to international tax law and the findings of these judgments would apply to LoBs as well.[79] The nationality clauses in the *Open Skies* cases functioned in the same way as the ownership test in a LoB clause. The only difference is that a LoB clause usually does not contain a nationality requirement but does contain a residence requirement. However, in the field of direct taxation, the CJEU has already ruled that residence and nationality are similar concepts and that in tax cases residence requirements are most likely to have consequences similar to nationality requirements in other fields of law.[80] The widespread opinion expressed in the literature was that if the CJEU was to find one set of treaties (*Open Skies*) to be incompatible with EU law it might also condemn the other set of treaties (*tax treaties*).

Not long after the judgments in the *Open Skies* cases LoB clauses played a more central role in another CJEU ruling although the CJEU did not address the (in-)compatibility of the LoB clause in question directly in this later case. The *ACT Group Litigation*[81] ruling focused on the refusal by the Commissioners of Inland Revenue to grant a tax credit to non-resident companies for dividends paid to them by resident companies. The UK advance corporation tax (ACT) was an imputation system whereby a UK corporation would pay a tax with respect to dividends payable to its shareholders. That tax was available as a tax credit to the corporation's UK resident shareholders but was not available to foreign shareholders unless specifically authorised under a tax treaty.

One of the questions referred to the CJEU focused specifically on the interplay between the UK ACT, the specific rule in the UK–Netherlands Tax Treaty providing for the tax credit to be paid to Dutch shareholders and the LoB clause of that Tax Treaty denying treaty benefits to Dutch companies primarily held by non-resident shareholders: is it contrary to the freedom of establishment

[78] See, e.g. *Hanns-Martin Bachmann v Belgian State* (C-204/90) [1992] ECR I-249 at [21] and following; *Commission of the European Communities v Kingdom of Belgium* (C-300/90) [1992] ECR I-305 at [14] and following; *P. H. Asscher v Staatssecretaris van Financiën* (C-107/94) [1996] ECR I-3089 at [49] and following; *Rolf Dieter Danner. Reference for a preliminary ruling: Kuopion hallinto-oikeus – Finland* (C-136/00) [2002] ECR I-8147 at [33] and following and [44] and following; *Futura Participations SA, Singer v Administration des contributions* (C-250/95) [1997] ECR I-2471 at [26]; *X and Y v Riksskatteverket* (C-436/00) [2002] ECR I-10829 at [49]; see further Kofler, above fn.10, 63; Clark, above fn.59; C. Panayi, "Open Skies for European Tax?" [2003] BTR 198.
[79] See Kofler, above fn.10, 63; Clark, above fn.59; Mason, above fn.59.
[80] See, e.g. *Finanzamt Köln-Altstadt* (C-279/93), above fn.68, [1995] ECR I-225.
[81] *ACT Group Litigation* (C-374/04), above fn.76, [2006] ECR I-11673.

> "for Member State A (such as the United Kingdom) not to confer an entitlement to a partial tax credit in respect of relevant dividends on a company resident in Member State C (such as the Netherlands) which is controlled by a company resident in Member State B (such as Germany) when Member State A gives effect to provisions in double taxation conventions which confer such an entitlement on companies resident in Member State C which are controlled by residents of Member State C".[82]

The CJEU concluded, however, that there was no discrimination largely because there was no comparability between UK shareholders, on the one hand, and foreign non-resident shareholders, on the other hand.[83] Even though the ACT credit is necessary in a purely UK setting where the credit is used to offset UK tax at the shareholder level, the fact that the UK has no control over the ultimate treatment of foreign shareholders relieves the UK from granting a tax credit to a foreign resident with respect to outbound dividends.[84]

In concluding that the UK was not acting in a discriminatory fashion by not granting the tax credit to foreign shareholders the CJEU noted that, in the absence of any unifying or harmonising measures, EU Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation.[85] The CJEU took the view that the benefits of tax treaties are inherently intended to apply only to persons resident in (one of) the two Contracting States. There is no reason to extend the benefits to residents of a third country (not even if all countries are EU Member States). Thus, it is, according to the CJEU, not discriminatory for the contracting Member State to limit the benefits of a tax treaty to its own residents.[86] While the LoB clause in the UK–Netherlands Tax Treaty was not addressed directly by the CJEU, the tenor of the ruling suggests that a Dutch company controlled by residents of the Netherlands and a Dutch company controlled by non-resident shareholders are not in a comparable tax position with regard to the UK.[87] Therefore, a discrimination does not exist and the interplay of the LoB clause and the ACT does not need to be addressed further.

It is obvious that the judgments in the *Open Skies* cases appear to be in conflict with the judgment in *ACT Group Litigation* to the extent that Member States may not conclude agreements that are in violation of TFEU freedoms. However, since the pattern of tax relationships is far more complex than the network of *Open Skies* agreements both the judgments in the *Open Skies* cases and the judgment in *ACT Group Litigation* are difficult to compare. While the CJEU ruled that a nationality-based denial of treaty benefits was discriminatory and contrary to the freedom of establishment in the *Open Skies* judgments, it upheld a residence-based denial of treaty benefits in the tax setting and did not find a discrimination. Yet, all these judgments avoided addressing directly the character of the LoB clause in tax treaties. Thus, even after *ACT Group Litigation* there is significant uncertainty and also division among commentators[88] as to whether or not

[82] *ACT Group Litigation* (C-374/04), above fn.76, [2006] ECR I-11673 at [29].
[83] *ACT Group Litigation* (C-374/04), above fn.76, [2006] ECR I-11673 at [58] and following.
[84] Osterweil, above fn.59; Plansky and Schneeweiss, above fn.59; Debelva, et al., above fn.59.
[85] *ACT Group Litigation* (C-374/04), above fn.76, [2006] ECR I-11673 at [52].
[86] Osterweil, above fn.59; Plansky and Schneeweiss, above fn.59; Dourado, above fn.59; Debelva, et al., above fn.59.
[87] *ACT Group Litigation* (C-374/04), above fn.76, [2006] ECR I-11673 at [87].
[88] Kemmeren (2014), above fn.59; Calejo Guerra, above fn.59; Bates, et al., above fn.52; Mason, above fn.59; Kofler, above fn.10, 63; Clark, above fn.59; Dourado, above fn.59; Osterweil, above fn.59; Plansky and Schneeweiss, above

current LoB clauses with the US and the LoB clause of new Article 29 OECD MC will eventually be upheld by the CJEU.

4.2.2. Is there a justification?

Even though its judgment in *ACT Group Litigation* shows some propensity on the part of the CJEU to uphold a LoB clause, its conflicting view in the *Open Skies* judgments requires a discussion of possible justifications for the differing (and maybe discriminatory) treatment caused by the LoB clause. To justify the use of LoB clauses to prevent treaty shopping, several aspects have to be considered. First, as the aim of treaty shopping is to benefit from the withholding tax reduction provided for by the tax treaty that "is shopped", the prevention of treaty shopping is in general in the interest of the source country. The source country however is the US. The CJEU's existing case law addresses exclusively the anti-avoidance rules of EU Member States.[89] It is highly questionable whether the prevention of avoidance of taxes imposed by a third country could be seen as a justification for an overt discrimination.

It might be argued that the principles underlying every tax treaty are those of reciprocity and bilateralism. The principle of bilateralism would be obstructed if a resident of a third country derived benefits from a treaty intended to serve only the interests of residents of the two Contracting States. Preventing this third country resident from unduly benefiting from the treaty is in the interests of both Contracting States irrespective of the country that actually applies the bilateral anti-avoidance provision. Similarly, the principle of reciprocity[90] might be used to argue that the infringement of the fundamental freedoms is justified. Negotiating a bilateral tax treaty requires both parties to make concessions with respect to their source-based taxing rights. The source country (fully or partially) relinquishes its right to tax domestic source income earned by residents of the other country and reciprocally receives the same concessions for its residents. The general assumption is that tax treaties have revenue neutral effects: a provision resulting in reduction of revenue will be offset by other provisions increasing revenue.[91] An EU Member State may thus argue that preventing treaty shopping with regard to US withholding taxes has a reciprocal effect and therefore (also) protects its own tax base.[92]

It should be noted, however, that intended or unintended double non-taxation caused by the national tax laws of Member States is not incompatible with EU law.[93] The Member States are not required to adapt their own tax systems to different Member State (or third country) tax systems to eliminate double non-taxation. If both are the result of the parallel and non-discriminatory exercise of tax competences by different Member States it is not prohibited by EU law notwithstanding the tax advantages that could accrue to some taxpayers.[94] In addition,

fn.59; Debelva, et al., above fn.59; C. Panayi, "The Compatibility of the OECD/G20 Base Erosion and Profit Shifting Proposals with EU Law" (2016) 70(1/2) *Bulletin for International Taxation* 95.

[89] See, e.g. *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* (*ICI*) (C-264/96) [1998] ECR I-4695 at [26].

[90] See, e.g. *D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen* (C-376/03) [2005] ECR I-5821 at [61].

[91] See Rosenbloom, above fn.13, 774; Haug, above fn.11, 218.

[92] See Terra and Wattel, above fn.61, 77.

[93] See Panayi, above fn.88.

[94] Panayi, above fn.88.

double non-taxation is not accepted as a justification of a restriction of fundamental freedoms. While double non-taxation results in a loss of tax revenue for the Member State concerned, the loss of tax revenue (base erosion) was never allowed as a justification by the CJEU.[95] The emphasis has always been on justifications on the basis of tax evasion.[96] Obtaining a mere tax saving has never been equated to tax evasion in the view of the CJEU. The reciprocity and bilateralism argument is thus most likely not valid.[97]

However, if it is assumed that the reciprocity and bilateralism argument is valid, the measures to prevent tax avoidance must be able to achieve their aim while at the same time they must not go beyond what is necessary for that purpose. Since the CJEU has already held that tax avoidance (or evasion) cannot generally be inferred from the fact that a parent company is established in another Member State,[98] a measure that applies whenever the parent company has its seat in a different Member State from that of the subsidiary cannot be justified automatically by the aim of preventing tax avoidance. Additionally, the CJEU has stated that "a general presumption of tax evasion or tax fraud cannot justify a fiscal measure"[99] in which the "contested measure consists in an outright prohibition on the exercise of a fundamental freedom".[100] It must thus be demonstrated that treaty shopping, that is the activity that these anti-abuse provisions seek to curb, is an activity which is not protected under EU law. The more abusive the structure, the less likely it is that the fundamental freedoms can be applied at all.[101] Therefore, the more economic substance there is in the intermediary company itself, the more likely it is that the setting up of the subsidiary is an activity that is covered by the freedom of establishment.[102] Yet, if the intermediary entity is a complete sham, then there is arguably no genuine exercise of the freedom of establishment.

It follows that the anti-treaty shopping provisions must have the specific purpose of preventing wholly artificial arrangements. Broad anti-abuse clauses that do not distinguish between bona fide activities and abusive situations might be condemned. Preventing tax avoidance and/or evasion could thus exonerate a restrictive treaty provision (only) if it is sufficiently targeted at this very aim. The provision must be suitable and must not go beyond what is necessary to attain the objective pursued. As a result, if an anti-treaty shopping provision applies to less than wholly artificial arrangements, the restriction is unlikely to be justified.[103] Conversely, the more artificial the treaty shopping arrangement, the more likely it is that an anti-treaty shopping provision can be justified.

[95] *ICI* (C-264/96), above fn.89, [1998] ECR I-4695 at [28]; *Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd v Commissioners of Inland Revenue and HM Attorney General* (Joined Cases C-397/98 and C-410/98) [2001] ECR I-1727 at [59]; *Compagnie de Saint-Gobain* (C-307/97), above fn.64, [1999] ECR I-6161 at [51]; *Staatssecretaris van Financiën v B.G.M. Verkooijen* (C-35/98) [2000] ECR I-4071 at [48]; *X and Y v Riksskatteverket* (C-436/00), above fn.78, [2002] ECR I-10829 at [50].
[96] Panayi, above fn.88.
[97] Kofler, above fn.10, 76.
[98] *X and Y v Riksskatteverket* (C-436/00), above fn.78, [2002] ECR I-10829 at [62]; see further *Centros* (C-212/97), above fn.67, [1999] ECR I-1459.
[99] *Commission of the European Communities v Kingdom of Belgium* (*Kingdom of Belgium*) (C-478/98) [2000] ECR I-7587 at [45].
[100] *Kingdom of Belgium* (C-478/98), above fn.99, [2000] ECR I-7587 at [45].
[101] Panayi, above fn.88.
[102] Panayi, above fn.88.
[103] Panayi, above fn.88; Kofler, above fn.10, 77.

Applying the above to the existing and proposed LoB clauses makes it clear that the various tests of LoB clauses do not provide a method which is flexible enough to pursue a case-by-case inquiry in to whether or not tax planning, tax avoidance or tax evasion has taken place. Moreover, since the general goal of the objective tests is to avoid making a subjective determination of the taxpayer's intent, the LoB clauses most likely represent a disproportionate anti-abuse measure, as they go beyond what is necessary for the purpose of countering treaty abuse.[104]

4.2.3. Derivative benefits clause

Many but not all LoB clauses in the current treaties between the US and EU Member States and also in new Article 29 OECD MC contain a "derivative benefits clause"[105] and the existing clauses are very heterogeneous. Some derivative benefits clauses are applicable only to certain types of income (for example, the US–Netherlands Tax Treaty) while some are applicable to the whole tax treaty (for example, the US–Luxembourg Tax Treaty). With regard to the ownership test of the derivative benefits clause, several tax treaties require that the shareholders of the company are residents of (third) countries that themselves have a comprehensive tax treaty with the US (for example, the US–Luxembourg Tax Treaty; the US–France Tax Treaty[106]) and some require that the third country has a comprehensive tax treaty with both the US and the EU Member State (for example, the US–Netherlands Tax Treaty). Other treaties however refer solely to residents of the European Economic Area countries (for example, the US–Denmark Tax Treaty and the US–UK Tax Treaty[107]) and do not require the existence of a comprehensive tax treaty. Some treaties limit the acceptable number of foreign shareholders to between five and seven (for example, the US–Ireland Tax Treaty; the US–UK Tax Treaty; the US–Luxembourg Tax Treaty) and/or require a certain ownership percentage (for example, the US–Denmark Tax Treaty; the US–Luxembourg Tax Treaty; the US–Ireland Tax Treaty). The base erosion test in derivative benefits provisions is usually not met if 50 per cent and more of gross income is transferred to non-qualified persons and taxed in a third country. But in the treaties with Luxembourg, the UK, Denmark, and Ireland, the base erosion test is met even if the whole gross income is used to make such payments provided that at least 50 per cent is transferred to qualified EU residents.

Additionally, the efficiency of the derivative benefits clause depends on the other clauses in the treaties of the involved countries. The derivative benefits clause compares the taxation of the actual three-country case (US → EU Member State 1 → EU Member State 2) with a fictitious two-country case (US → EU Member State 2). The taxation of these two situations depends on the specific rules for the specific type of income in the respective treaties of the involved countries (for example, the withholding tax reductions for interests). For example if the parent company is in Austria, Subsidiary 1 in Germany and Subsidiary 2 in the US, the derivative benefits clause in the Tax Treaty between Germany and the US applies if: 1. a tax treaty between the US and Austria exists; and 2. the reduction of the US withholding tax in the Germany–US Treaty equals the withholding tax reduction in the Austria–US Tax Treaty. In this specific case it depends on

[104] Kofler, above fn.10, 77.
[105] See Table 1.
[106] See further Galinier-Warrain, above fn.47.
[107] See J.F. Avery Jones, "First Impressions from the United Kingdom of the New United Kingdom-United States Tax Treaty" (2001) 55(11) *Bulletin For International Taxation* 557.

the type of income as to whether or not the derivative benefits clause is applicable: for dividends both treaties (Germany–US and Austria–US) reduce the US withholding tax to 5 per cent. For interest both treaties (Germany–US and Austria–US) reduce the US withholding tax to 0 per cent. For royalties however, the Germany–US Treaty is more advantageous (0 per cent withholding tax) than the Austria–US Treaty (5 per cent withholding tax). So, in two cases the derivative benefits clause does apply and in one case it does not apply.

Considering all 27 current tax treaties between EU Member States and the US one can find four different withholding tax rates for dividends (Article 10 OECD MC), three different withholding tax rates for interest (Article 11 OECD MC) and four different withholding tax rates for royalties (Article 12 OECD MC). In total, there are 702 possible combinations of tax treaties between EU Member States that can be considered for the application of derivative benefits clauses. The probability that any three-country case (US → EU Member State 1 → EU Member State 2) has the same or a more beneficial tax treatment than the respective fictitious two-country case (US → EU Member State 2) is thus rather small. See Table 2 for an overview of the withholding tax rates in the tax treaties between the US and EU Member States.

Table 2: withholding tax rates

	Dividends		Interest	Royalties
	Individuals, companies	Qualifying companies		
Treaty with:	Withholding tax rate (%)			
Austria	15	5	0	0/10
Belgium	15	0/5	0	0
Bulgaria	10	5	5	5
Croatia	n/a	n/a	n/a	n/a
Cyprus	15	5	10	0
Czech Republic	15	5	0	0/10
Denmark	15	0/5	0	0
Estonia	15	5	10	5/10
Finland	15	0/5	0	0
France	15	0/5	0	0
Germany	15	0/5	0	0
Greece	30	30	0	0
Hungary	15	5	0	0
Ireland	15	5	0	0
Italy	15	5	10	0/5/8
Latvia	15	5	10	5/10
Lithuania	15	5	10	5/10
Luxembourg	15	5	0	0
Malta	15	5	10	10
Netherlands	15	0/5	0	0/15

	Dividends		Interest	Royalties
	Individuals, companies	Qualifying companies		
Treaty with:	**Withholding tax rate (%)**			
Poland	15	5	0	10
Portugal	15	5	10	10
Romania	10	10	10	10/15
Slovak Republic	15	5	0	0/10
Slovenia	15	5	5	5
Spain	15	10	10	5/8/10
Sweden	15	0/5	0	0
United Kingdom	15	0/5	0	0

While the derivative benefits clause can mitigate the negative effects of the LoB clause in a specific case, it does not go far enough to address the problem of discrimination comprehensively.[108] If the ownership and base erosion test in a LoB clause is discriminatory, the problem is mitigated, but not solved, by reducing the scope of the discrimination through the derivative benefits concept. For as long as there remains even one case in which the discriminatory effect of the LoB clause cannot be eradicated the derivative benefits clause, the discriminatory character of the LoB clause, remains intact.[109] Considering the large number of possible tax treaty combinations and the fact that Croatia does not even have a tax treaty with the US, the probability of finding at least one situation in which the derivative benefits clause does not apply and is therefore unable to mitigate the discriminatory effect is rather high.

4.3. The CCCTB Directive—another layer?

The analysis provided above together with the previous literature on the interaction between EU law and LoBs focused on the (in)compatibility of LoBs with primary EU law (especially the freedom of establishment and the free movement of capital). The CCCTB however will be implemented as a directive, a type of EU secondary legislation. Therefore a second layer needs to be analysed when discussing the (in)compatibility of LoBs with EU law. The interplay between EU directives, their national implementation laws and tax treaties has not received overly much attention in the literature, however several articles have analysed this interaction with respect to the Parent–Subsidiary Directive.[110] In general, implemented directives always override a later tax treaty because the law higher up in the hierarchy trumps the lower one—“*lex superior derogate*

[108] See, e.g. Kofler, above fn.10, 71; Panayi, above fn.88, 200.
[109] See J. Malherbe and O. Delattre, “Compatibility of Limitation on Benefits Provisions with EC Law” (1996) 36(1) *European Taxation* 12, 20: “If the ‘happy few’ become many, there will still be unhappy ones to whom the courts are open.”
[110] Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2011] OJ L345/8.

legi inferiori".[111] This interaction however becomes problematic when an EU directive or its national implementation law overrides an existing bilateral treaty.

In certain circumstances, a Member State can rely on Article 351 TFEU which states that:

> "The rights and obligations arising from agreements concluded before 1 January 1958 or, for acceding States, before the date of their accession, between one or more Member States on the one hand, and one or more third countries on the other, shall not be affected by the provisions of the Treaties."[112]

Although the wording only refers to "provisions of the Treaties", it has been argued that secondary legislation is also covered.[113] This understanding is supported by the case law of the CJEU, according to which Article 351 TFEU

> "would not achieve its purpose if it did not imply a duty on the part of the institutions of the Community not to impede the performance of the obligations of Member States which stem from a prior agreement".[114]

Consequently, it may be argued that the Member States can abstain from renegotiating, terminating or overriding tax treaties that have been concluded with a third country before the date of their accession to the EU.[115]

In addition, it should even be considered possible to apply Article 351 TFEU by analogy to tax treaties concluded with third countries after 1 January 1958 or, for acceding Member States, after the date of accession, but before the implementation of the CCCTB Directive.[116] After all, Article 351 TFEU accommodates the international law principle of *pacta sunt servanda* as stated in Article 26 and Article 30(4)(b) of the Vienna Convention on the Law of Treaties.[117] When a state is party to successive treaties relating to the same subject matter international law principles require that a prior treaty takes precedence over a later treaty if the other contracting party to the prior treaty is not also a contracting party to the later treaty.[118] If the implementation of the CCCTB Directive was not foreseeable when the tax treaty with a third country was concluded, it would

[111] See G. Kofler and M. Tumpel, "Double Taxation Conventions and European Directives in the Direct Tax Area" in M. Lang, J. Schuch and C. Staringer (eds), *Tax Treaty Law and EC Law* (Vienna: Linde, 2007), 200.

[112] Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union [2016] OJ C202/01 Art.351.

[113] See, e.g. C. Marchgraber, "Cross-Border Tax Arbitrage, the Parent-Subsidiary Directive (2011/96) and Double Tax Treaty Law" (2016) 70(3) *Bulletin for International Taxation* 123, 131; J.M. Grimes, "Conflicts between EC Law and International Treaty Obligations: A Case Study of the German Telecommunications Dispute" (1994) 35(2) *Harvard International Law Journal* 535, 547 and following; S. Lorenzmeier, "Art. 351 AEUV" in E. Grabitz, M. Hilf and M. Nettesheim (eds), *Das Recht der Europäischen Union* (München: C.H. Beck, 2011), para.18. But see Pistone, above fn.64, 86 who states that "issuing a directive implies the acquisition to Community of all aspects regulated by it. Therefore, for the purpose of not contravening principles of Community law (i.e. Article 307 EC Treaty) the directive itself should contain a clause to regulate the conflict with treaty law."

[114] *Attorney General v Juan C. Burgoa* (C-812/79) [1980] ECR 2787 at [9]; *Air Transport Association of America and Others v Secretary of State for Energy and Climate Change* (C-366/10) [2011] EU:C:2011:864 at [61].

[115] Marchgraber, above fn.113, 131; S. Heidenbauer, "Internationale Aspekte der EU-Quellensteuer" (2006) 16(10) *Steuer und Wirtschaft International* 459, 466; Kofler, above fn.62, 424; Malherbe and Delattre, above fn.109, 14.

[116] See Marchgraber, above fn.113, 131 with respect to the Parent–Subsidiary Directive.

[117] UN Vienna Convention on the Law of Treaties (23 May 1969).

[118] See W. Hummer, "Artikel 351 AEUV" in C. Vedder and W. Heintschel von Heinegg (eds), *Europäisches Unionsrecht* (Baden-Baden: Nomos, 2012), para.3.

be understandable if the rights and obligations of such a tax treaty were not affected by the implementation of secondary EU legislation, which was not foreseeable at the time the tax treaty was negotiated.[119]

Nevertheless, it must be noted that Article 351 TFEU also states that:

> "To the extent that such agreements are not compatible with the Treaties, the Member State…concerned shall take all appropriate steps to eliminate the incompatibilities established."

Member States are, therefore, asked to work towards a renegotiation of those tax treaties concluded with third countries that are incompatible with the CCCTB regime.[120] If such attempts are not successful, the Member States would ultimately have to terminate or override such tax treaties.[121] After all, the Member States remain

> "obliged to eliminate any incompatibilities existing between the earlier agreement and the Treaty. If that Member State encounters difficulties which make adjustment of an agreement impossible, an obligation to denounce that agreement cannot therefore be excluded."[122]

5. Conclusion

The interplay between the proposed CCCTB concept in the CCCTB Proposal and the EU Member States' tax treaties with third countries is highly complex and non-trivial. The formulary apportionment proposed by the CCCTB draft directive (the CCCTB Proposal) causes a deviation of income determination and income taxation. Income derived from third country operations, irrespective of whether or not it is derived directly, via a permanent establishment or through a subsidiary, is not (exclusively) taxed in the EU Member State of the taxpayer running, maintaining or owning the foreign (third country) operations. Due to the apportionment procedure that income is allocated to all companies of the CCCTB group and subsequently (parts of it) taxed by all involved EU Member States.

The apportionment procedure raises several questions with regard to the applicability and effectiveness of the tax treaties negotiated by the EU Member State which is the residence state of the group company maintaining the foreign operations. In principle, the tax treaty would apply because of its residence clause. However, the LoB clauses provided for in 24 of the 27 existing tax treaties between the US and EU Member States compromise the application and effectiveness of these treaties. But the US is not the only country with which EU Member States have concluded LoB clauses.[123] Following the final report concerning the OECD BEPS Action Plan's Action 6, a LoB clause was included in the OECD MC as well as in the Multilateral Instrument. It is thus

[119] Marchgraber, above fn.113, 131.
[120] Hummer, above fn.118, para.18; Lorenzmeier, above fn.113, para.18; E. Petersmann and C. Spennemann, "Artikel 307 EG" in H. von der Groben and J. Schwarze (eds), *Kommentar zum Vertrag über die Europäische Union und zur Gründung der Europäischen Gemeinschaft* (Baden-Baden: Nomos, 2003), para.1; F. Vanistendael, "The Limits of the New Community Tax Order" (1994) 31(2) *Common Market Law Review* 293, 303; Marchgraber, above fn.113, 131.
[121] Kofler, above fn.62, 433–435; Marchgraber, above fn.113, 131.
[122] *Budějovický Budvar, národní podnik v Rudolf Ammersin GmbH* (C-216/01) [2003] ECR I-13617 at [170].
[123] See, e.g. the tax treaties between The Netherlands and Japan (applicable since April 2012), Australia and Germany (applicable since January 2017) or Taiwan and Sweden (applicable since January 2005).

plausible to assume that future tax treaties between EU Member States and third countries will contain such provisions more frequently. Therefore the significance of the question of whether or not LoBs in general and, more specifically, whether the interplay between LoBs and the proposed CCCTB concept in the CCCTB Proposal are compatible with EU law expands beyond current US–EU relations.

The analysis shows that there is no clear-cut answer to this question. The CJEU has not directly addressed LoB clauses in its previous case law. There are, however, two important judgments that provide some guidance as to how the CJEU would rule specifically on LoB clauses. These two judgments are, however, mutually contradictory. The *Open Skies* judgments condemned a differential treatment of companies based on the nationality of their shareholders provided for in bilateral (US–EU Member States) air transportation treaties. In *ACT Group Litigation* the CJEU did not, however, find a differential treatment of companies based on the residence of their shareholders as provided for in bilateral (between EU Member States) tax treaties to be discriminatory. Even though the judgment in *ACT Group Litigation* did not address the specific LoB clause of the particular tax treaty between the Netherlands and the UK, many commentators view the judgment as an indication that the CJEU would uphold bilateral LoB clauses. Yet, there is no consensus on this issue in the literature as many commentators stress the fact that the CJEU did not explicitly rule on the LoB clause and disregarded specific aspects of the case.

The EU Commission has recently omitted to address the issue of LoB clauses, both in the CCCTB Proposal and in other recent publications and initiatives. The issue of whether LoB clauses are compatible with EU law has, however, been brought to the attention of the European Commission. As early as 1990 the Commission was asked whether or not it agreed that LoB provisions contravened the TFEU and that all EU residents should be treated equally as qualified shareholders under those clauses.[124] While a specific answer to this question was never published, the Commission indicated in several subsequent documents that it viewed LoB clauses as potentially discriminatory.[125]

Be that as it may, there is substantial legal uncertainty regarding the compatibility of the LoB clauses with EU law. For the purposes of the functioning of the CCCTB concept with respect to third country income, the application of the LoB clause is critical: either the LoB clause is applicable which means that the treaty benefits are not granted to a company that is part of a CCCTB group or the LoB clause is not compatible with EU law with unclear results. In the latter case, if the LoB clause is not compatible with EU Law, the CJEU would hold the respective EU Member State responsible for the discrimination. In practice, this would mean that this EU Member State would not be allowed to apply the discriminatory treaty provision. However, if the EU Member State does not apply the discriminatory provision in the first place, the provision is in general applied by the third country (denial of withholding tax reduction). The powers to enforce such a CJEU ruling would be very limited. If the EU Member State subsequently terminates the treaty with, for example, the US, the taxpayer would find itself in a worse position

[124] Written Question No.2046/90 by Mr Gijs de Vries to the Commission of the European Communities (5 September 1990) (91/C79/47) [1991] OJ C79/28 (25 March 1991).

[125] See European Commission, *Report of the Committee of Independent Experts on Company Taxation* (Ruding Report) (1992), 206; European Commission, *EC Law and Tax Treaties* (2005, TAXUD E1/FR DOC (05) 2306).

than before. Thus, in basically every scenario, whether the LoB is compatible with EU law, whether it is incompatible but the treaty remains in place or whether the LoB is incompatible and the treaty is terminated, the benefits of the treaty (for example, withholding tax reduction) would not apply to the CCCTB group because of both the built-in base erosion of the apportionment procedure (base erosion test) and the ownership test of the LoB clause.

Perhaps the only feasible way both to make the CCCTB concept compatible with the tax treaties of the EU Member States with third countries that contain LoBs and to reduce the general legal uncertainty regarding the compatibility of the LoB clauses with EU law is to renegotiate and adjust those LoB clauses.[126] Technically this could be done with a protocol.[127] But what needs to be changed materially? There are two possible solutions: 1. adjust the ownership and base erosion tests so that non-resident EU shareholders are disregarded for the ownership test and tax deductible payments to residents of other EU Member States do not activate the base erosion test; 2. expand the derivative benefits clause to include residents of all EU Member States irrespective of whether a comprehensive tax treaty between the other EU Member State and the third country exists and/or irrespective of whether such a treaty provides for the same treaty benefits. These changes to the LoB clauses could apply to all corporations resident in any EU Member States or the changes could apply to only CCCTB companies. The latter would reduce the vulnerability to treaty shopping and tax avoidance of the new (and reduced in scope) LoB clause, however it could raise additional concerns about discrimination and compatibility with EU law and/or national constitutional laws.

The success of such a renegotiation depends primarily on the relative negotiation powers of the involved countries. With respect to the US and the inferior negotiating power of some smaller EU Member States, renegotiating will not be an easy task. This is especially because the US was unwilling in the first instance to abstain from negotiating LoB provisions as such and it was also unwilling to draft LoB clauses in such a way as to reflect the EU membership of its treaty partners. Therefore, and also to ensure an increased level of harmonisation, the EU Member States could/should co-ordinate the negotiations of their tax treaties with third countries under the auspices of the European Commission.[128]

Following the *Open Skies* judgments the European Commission and the EU Member States agreed to this approach. On 2 March 2007 the European Commission and the EU Member States on the one hand and the US on the other hand signed (and later ratified) a comprehensive, multilateral air transportation agreement.[129] However, unlike air transportation, direct taxation in the EU is not comprehensively covered by EU legislation. Although the Member States have to exercise their powers in accordance with EU law, tax sovereignty is retained by each country and each preserves its competence to enter into bilateral agreements with third countries. However,

[126] See Mason, above fn.59; Kofler, above fn.10.
[127] Kofler, above fn.10.
[128] This is a rather old recommendation that was first included in the Ruding Report, above fn.125 (published in 1992), 206.
[129] 2007/339/EC Decision of the Council and the Representatives of the Governments of the Member States of the European Union, meeting within the Council of 25 April 2007 on the signature and provisional application of the Air Transport Agreement between the European Community and its Member States, on the one hand, and the United States of America, on the other hand. Air Transport Agreement [2007] OJ L134/1, available at: *http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:L:2007:134:FULL&from=EN* [Accessed 12 February 2018].

the influence of the CJEU's case law, which selectively removes the discriminatory elements of Member States' tax systems albeit without being able to establish a coherent and consistent non-discriminating (international) tax system for Member States, must not be forgotten. Therefore, to achieve greater consistency and compatibility among treaty provisions and to ensure the functioning, effectiveness and attractiveness of the proposed CCCTB concept in the CCCTB Proposal, the European Commission may suggest co-ordinating tax treaty negotiations or even negotiating tax treaties on behalf of all EU Member States[130].

[130] See F. Vanistendael, "Impact of European tax law on tax treaties with third countries" (1999) 8(3) *EC Tax Review* 163; Kaye, above fn.59; Anders, above fn.15; Kofler, above fn.10; Mason, above fn.59.

Base erosion and profit shifting; Common consolidated corporate tax base; Double taxation treaties; EU law; Groups of companies; Limitation-on-benefits clauses; Tax administration; United States