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# Tax Treaties and Most-Favoured-Nation Treatment, particularly within the European Union

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## Abstract

Tax treaties contain benefits for taxpayers resident in the contracting states. Since tax treaties are negotiated on the basis of the particular economic and sometimes political relationship between the contracting states, the benefits may vary between different tax treaties. Therefore, the question arises whether a resident/national of a third state may claim from a contracting state the benefits of a tax treaty if this tax treaty is more advantageous than that concluded by the third state and the contracting state concerned. From the states´ perspective the question is whether a state must grant to a non-resident/non-national a benefit which is contained in the tax treaty concluded by this state and a state other than the state of residence/nationality of the taxpayer invoking the benefit. In other words, the issue is whether states are obliged to afford most-favoured-nation treatment as regards tax treaty benefits.

This paper discusses whether an obligation to grant most-favoured-nation treatment may be based on International Tax Law, International Trade Law or EC Law. The latter area is of particular interest since the European Court of Justice has recently delivered its decision on the so-called "D" case in which it dealt with the issue for the first time in substance.

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**Kommunikation**

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## Abbreviations

| | |
|---|---|
| AG | Advocate General (at the European Court of Justice) |
| Art(s) | Article(s) |
| BFH | (German) Federal Fiscal Court (*Bundesfinanzhof*) |
| BStBl. | (German) Federal Tax Gazette (*Bundessteuerblatt*) |
| EC | European Community *or* Treaty Establishing the European Community |
| ECJ | European Court of Justice |
| ECR | European Court Reports |
| et seq(q.) | and the following |
| fn(s) | footnote(s) |
| GATS | General Agreement on Trade in Services |
| GATT | General Agreement on Tariffs and Trade |
| GG | (German) Basic Law (*Grundgesetz*) |
| ICJ | International Court of Justice |
| ICJ Statute | Statute of the International Court of Justice |
| NAFTA | North American Free Trade Agreement |
| OECD | Organization for Economic Cooperation and Development |
| OECD Model | OECD Model Convention with respect to Taxes on Income and on Capital |
| OJ | Official Journal of the European Communities |
| para(s) | paragraph(s) |
| s. | section |
| US-Germany FCN Treaty | Treaty of Friendship, Commerce and Navigation between the United States of America and the Federal Republic of Germany |
| WTO | World Trade Organization |

# 1 Introduction

Tax treaties contain benefits for taxpayers resident in the contracting states. Since tax treaties are negotiated on the basis of the particular economic and sometimes political relationship between the contracting states, the benefits often vary from treaty to treaty. The question therefore arises whether a resident/national of a third state may claim from a contracting state the benefits of a tax treaty that is more favourable than the treaty concluded by the third state and the contracting state concerned. From the states' perspective, the question is whether a state must grant to a nonresident/non-national a benefit contained in the tax treaty concluded by that state and a state other than the state of residence/nationality of the taxpayer claiming the benefit. In other words, the issue is whether states are obliged to afford most-favoured-nation (MFN) treatment regarding tax treaty benefits.[1]

The obligation to grant MFN treatment to non-residents/non-nationals may be based on a number of different grounds. This article discusses these options and their impact on tax treaty benefits. The article first considers whether and to what extent international tax law and international trade law oblige states to afford MFN treatment regarding tax treaty benefits (see 2.). Due to the economic importance of the European Community (EC) as one of the three pillars of the European Union and the increasing influence of EC law on the national tax laws of the Member States, the position of EC law is considered in detail (see 3.). The issue is currently debated in the EC following the recent decision of the European Court of Justice (ECJ) in the "*D*" case in which it dealt with this issue substantively for the first time.[2] A conclusion closes the article (see 4.).

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[1] For the term "most-favoured-nation treatment" and a good example of the relevance of the issue, see e.g. Weggenmann, H., "EG-rechtliche Aspekte steuerlicher Meistbegünstigung im Abkommensrecht", 12 *Internationales Steuerrecht* 677 (2003). The example involves a partnership established in State P which receives dividends from State S and whose partners are resident in States A and B. The partnership is treated as transparent by all the states concerned. Therefore, the partners are treated according to different tax treaties (the S–A and S–B treaties) which may have different withholding tax limits. Regarding the dividends, the issue is whether State S must treat all the partners according to the most favourable tax treaty.

[2] Case C-376/03, *D v. Inspecteur van de Belastingdienst, Particulieren/Ondernemingen Buitenland te Heerlen*, ECJ judgement of 5 July 2005, [2005] ECR I-5821 (*D*). The issue of MFN treatment has been referred to the ECJ before the "*D*" case, but the ECJ abstained from commenting on the issue because it was not relevant for the decision in those cases. See 3.2.

# 2 Tax Treaties and MFN Treatment in International Tax Law and International Trade Law

## 2.1 International tax law

The discussion first considers whether international tax law contains an obligation to apply the MFN principle. Apart from the national tax laws on the international aspects of taxation, tax treaties are the main source of international tax law.[3] Tax treaties are therefore the key to the answer to the question whether international tax law contains an MFN clause. The OECD Model Tax Convention on Income and on Capital does not have an MFN clause. Since many tax treaties are modelled on the OECD Model,[4] the absence of such a clause in the OECD Model is a clear indication that MFN treatment is not a general rule of international tax law.

Until 1992, this was expressly stated in the Commentaries on the OECD Model.[5] In the 1992 revision of the Commentaries, this comment was deleted without substitution. It might be argued that the removal of this comment indicates a change in international tax law – from the absence of a general MFN clause to the existence of one.[6] Actual tax treaty practice, however, shows that the revision of the Commentaries cannot be interpreted this way. MFN clauses can be observed in a number of tax treaties,[7] though not in all. In most cases, MFN clauses in tax treaties are not general, but are restricted to particular aspects of international taxation.[8] From this, it may be concluded that MFN treatment is regarded as an exception.[9] If MFN treatment was a gen-

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3 See Schaumburg, H., *Internationales Steuerrecht* (2nd ed., 1998), Para. 3.7 et seq.; and Vogel, K., in Vogel, K. (ed.), *Double Taxation Conventions* (3rd ed., 1997), Introduction, Para. 15 et seq.

4 See Farmer, P., "EC Law and Double Tax Agreements", 3 *EC Tax Journal* 137 (1999).

5 See Para. 54 et seq. on Art. 24 of the 1977 Commentaries. It is noteworthy that Australia, Canada and New Zealand expressed their objection to Art. 24 of the OECD Model.

6 See Rädler, A.J., "Meistbegünstigung im europäischen Steuerrecht", in Burmester, G. and D. Endres (eds.), Außensteuerrecht, Doppelbesteuerungsrecht und EU-Recht im Spannungsverhältnis Festschrift für Helmut Debatin zum 70. Geburtstag (1997), at 334, 335 (questioning whether this might have been the effect of the revision of the Commentaries).

7 For a comprehensive overview, see Hofbauer, I., "Most-Favoured-Nation Clauses in Double Taxation Agreements – A Worldwide Overview", 33 *Intertax* 445 (2005). See also Hofbauer, I., "Das Meistbegünstigungsprinzip in den deutschen und österreichischen Doppelbesteuerungsabkommen", 13 *Internationales Steuerrecht* 667 (2004), at 668 et seq.; Pistone, P., *The Impact of Community Law on Tax Treaties: Issues and Solutions* (2002), at 208 et seq.; and Rädler, supra note 6, at 337 et seq.

8 See Hofbauer, "Das Meistbegünstigungsprinzip in den deutschen und österreichischen Doppelbesteuerungsabkommen", supra note 7, at 668.

9 See id. at 672; Rädler, supra note 6, at 339; Stockmann, F., "Völkerrechtliche Meistbegünstigungsklausel und Internationales Steuerrecht", *Internationales Steuerrecht* 129 (1999), at 133; and Wolvers, S., "Tax Treaties and Most-Favoured-Nation Treatment in the European Community – Report of the Third ACIL Seminar on International and European Taxation held on 10 March 2005", 45 *European Taxation* 6 (2005), at 255, 256 (comments of E. Kemmeren).

eral principle (based on customary international law[10]), the contracting states would not have to agree on it in their tax treaties. In addition, the limitations on the scope of the existing MFN clauses vary to such an extent that a particular ("habitual") content of MFN clauses cannot be deduced. The existence of an MFN obligation based on customary international law would require *consuetudo*, which does not exist under such circumstances.[11] Finally, many MFN clauses in tax treaties (as well as in bilateral trade agreements) have their origin in the special relationship between the contracting states. Such a special relationship may be due to the fact that one contracting state is a former colony of the other or that the economies of the contracting states are deeply interdependent.[12] The negotiation of a (unilateral) MFN is sometimes the result of the predominant economic strength of one contracting state.[13] These particular circumstances may not be generalized, resulting in the conclusion that MFN clauses generally exist.

## 2.2 International trade law

The implications of international trade law for tax treaties are more complicated for two reasons. First, international trade law consists of a multitude of sources. Unlike international tax law, which comprises mainly bilateral treaties, international trade law also entails a large number of multilateral treaties. Second, it is doubtful whether trade agreements cover direct taxes and, in particular, tax treaties.

Turning first to multilateral trade agreements, they play an important role in a globalized world. The GATT, GATS and NAFTA are well-known and important examples of multilateral trade agreements, and they all contain a general MFN clause,[14] obliging the signatories to afford MFN treatment to the citizens of the other signatories. The MFN clauses in multilateral trade agreements are unrestricted and therefore cover all areas that may impose obstacles on international trade. Accordingly, taxation may also

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[10] Customary law is another source of public international law (see Art. 38(2) of the International Court of Justice Statute). It has only little importance in international tax law. See Schaumburg, supra note 3, Para. 3.12 et seq.

[11] See Brownline, I., *Principles of Public International Law* (1999), at 4 et seq.

[12] See Pistone, supra note 7, at 208 et seq.; Zester, A., "Can the Most-Favoured Nation Principle Influences the Use of Limitation on Benefits Clauses in Tax Treaties?", 34 *Intertax* 143 (2006), at 144. For critical comments, see Hofbauer, "Most-Favoured-Nation Clauses in Double Taxation Agreements – A Worldwide Overview", supra note 7, at 448.

[13] See Kramer, S., "Die Meistbegünstigung", 35 *Recht der Internationalen Wirtschaft* 473 (1989), at 474. For a critical view, see Hofbauer, "Most-Favoured-Nation Clauses in Double Taxation Agreements – A Worldwide Overview", supra note 7, at 448.

[14] See Art. I of the General Agreement on Tariffs and Trade (GATT), Art. II of the General Agreement on Trade in Services (GATS) and Arts. 308, 1003, 1103, 1203 and 1406 of the North American Free Trade Agreement (NAFTA). In addition to these trade agreements, one may wonder whether general public international law contains an MFN obligation that also covers the field of direct taxation. See de Graaf, A. and G. Janssen, "The implications of the judgment in the D case: the perspective of two non-believers", 14 EC Tax Review 173 (2005), at 175.

be covered by these MFN clauses. Doubts arise regarding direct taxes because some trade agreements apply only to "taxes on goods" (see e.g. Art. I of the GATT). This wording points to indirect taxes as the sole subject of multilateral trade agreements in the field of taxation. For that reason and because taxation is a delicate area due to its far-reaching impact on public revenue, one may argue that direct taxes are generally excluded from provisions that endanger the signatories' public revenue.[15]

In the context of this article, only tax treaties, not all aspects of direct taxation, are relevant. It is not necessary to consider further the preliminary issue of the general applicability of multilateral trade agreements to direct taxes since such agreements have almost no influence on tax treaties. Multilateral trade agreements enable the signatories to reserve their rights as regards tax treaties and usually defer to bilateral tax treaties. The GATS (Art. XIV(e)) and NAFTA (Art. 2103) explicitly exclude the applicability of MFN clauses to tax treaties. The GATT does not expressly do so, but there is no doubt that the MFN clause in the GATT does not prevail over the tax treaties concluded by the GATT's signatories. Exceptions to the scope must usually be part of the agreement, but exceptions may also be established by customary international law.[16] The discussion here does not consider requirements for establishing customary international law[17] are met for excluding tax treaties from the GATT. The exclusion of tax treaties from the GATT complies with the signatories' intention as expressed in the Uruguay Round.[18] The conclusion of tax treaties is mainly a political decision that should not be affected by the GATT.[19] Therefore, it should be taken for granted that multilateral trade agreements do not apply to tax treaty benefits.

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[15] There are, however, also good reasons for applying multilateral trade agreements to direct taxes. See Hofbauer, I., "To What Extent Does the OECD Harmful Tax Competition Project Violate the Most-Favoured-Nation Obligations under WTO Law", 44 *European Taxation* 9 (2004), at 400, 401 et seq. See also Fischer-Zernin, J., "Regelungen des internationalen Steuerrechts in zwischenstaatlichen Handelsabkommen Dargestellt am Beispiel der FCN-Verträge und des GATT-Vertrages", 34 Recht der Internationalen Wirtschaft 286 (1988), at 292; and Kraft, G. and K. Robra, "Das völkerrechtliche Meistbegünstigungsprinzip und seine Bedeutung im Europäischen Steuerrecht", 51 *Recht der Internationalen Wirtschaft* 247 (2005), at 248 et seq. (in favour of applicability, with a comprehensive discussion of the arguments against applicability). The applicability of Art. III of the GATT (national treatment) to direct taxes has been confirmed by various decisions of the WTO Panel. See Trottmann, C., "Ertragsteuerrecht, Warenverkehr und Inländergleichbehandlung vor der Welthandelsorganisation (WTO)", 13 *Internationales Steuerrecht* 661 (2004). The applicability of the GATS is not in doubt since Art. XIV(e) of the GATS explicitly refers to both services and service suppliers. The application of the MFN treatment clauses in the NAFTA to direct taxation is explicitly excluded (see Art. 2103 of the NAFTA). For a general view on the relationship between the MFN clauses in trade agreements and international tax law, see Stockmann, supra note 9, at 129 et seq.

[16] See Kramer, supra note 13, at 477.

[17] For the general requirements of customary international law, see Brownline, supra note 11, at 4 et seq.

[18] See Hinnekens, L., "Compatibility of Bilateral Tax Treaties with European Community Law. The Rules", 3 *EC Tax Review* 146 (1994), at 157 (citing the view of the signatories in the Uruguay Round).

[19] See Hofbauer, supra note 15, at 403.

In addition to multilateral trade agreements, international trade law consists of a large number of bilateral trade agreements, many of which include a general MFN clause.[20] It is doubtful that these general MFN clauses also apply to the field of taxation. It could be argued that, because they are unrestricted, taxation is automatically covered.[21] Instead of such a general MFN clause, which does not specifically address taxation, some MFN clauses in bilateral trade agreements expressly include direct taxes. A prominent example of the latter is Art. XI(3) of the Treaty of Friendship, Commerce and Navigation between the United States and Germany (US-Germany FCN Treaty).[22] Some bilateral trade agreements have limited MFN clauses which apply exclusively to the field of tax law.[23]

Due to the importance of taxation to public revenue, if direct taxes are covered by a bilateral trade agreement, they are usually subject to reservations similar to those in multilateral trade agreements. Accordingly, a party to such a bilateral agreement may reserve the right to grant benefits in tax treaties.[24] Bilateral trade agreements sometimes also provide that the mutual protection of revenue or the tax advantages accorded on the basis of reciprocity may constitute exceptions.[25] Both grounds may be used as the justification for excluding tax treaty benefits from an MFN clause.

## 3 Tax Treaties and MFN Treatment under EC Law

The above comments have shown that general international tax law does not oblige states to afford MFN treatment regarding tax treaty benefits and that MFN clauses in trade agreements also do not apply to tax treaties. Thus, MFN treatment is only of little relevance in the context of tax treaties. The issue arises whether EC law establishes an MFN obligation regarding tax treaty benefits.

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[20] See e.g. Lampe, M.H., "Bedeutung von Meistbegünstigungsklauseln in Handelsabkommen für das Ertragsteuerrecht", 7 *Internationales Steuerrecht* 483 (1998), footnotes 7 and 8. See also de Graaf and Janssen, supra note 14, at 174 et seq. (pointing out that the association agreements of the EC and the Member States with third states may also be considered as bilateral trade agreements).

[21] This view is questioned, however. See Fischer-Zernin, supra note 15, at 287.

[22] For the tax implications of this treaty, see generally Kempf, A., "Versteckte Vorschriften zur Vermeidung der Doppelbesteuerung im Verhältnis Deutschland – USA", 6 *Internationales Steuerrecht* 545 (1997).

[23] See e.g. Lampe, supra note 20, at 483, footnote 6.

[24] See e.g. Art. XI(5b) of the US–Germany FCN Treaty. For other examples, see Fischer-Zernin, supra note 15, at 287; and Lampe, supra note 20, at 483, footnote 9. The same is true for association agreements. See de Graaf and Janssen, supra note 14, at 174 et seq.

[25] See e.g. Arts. XI(5b) (mutual protection of revenue) and Art. XI(5a) (tax advantages accorded on the basis of reciprocity) of the US–Germany FCN Treaty. For the relationship between the exceptions in Arts. XI(5a) and (5b), see Lampe, supra note 20, at 484 et seq.

## 3.1 Direct taxation, tax treaties and EC law in general

The impact of EC law on the national laws of the Member States has been increasing tremendously, and almost all areas of law relevant to cross-border business activities are affected. The aim of the EC is to establish a functioning internal market.[26] To achieve this, the EC law aimed at establishing the internal market must prevail over the national laws. This result is commonly acknowledged, albeit the legal reasoning supporting the supremacy of EC law varies.[27]

In principle, the economic integration of the Member States may be facilitated by two different methods of legal integration. The first is "positive integration", which is implemented mainly by way of legislative measures such as regulations and directives.[28] In the field of direct taxation, there are only a limited number of directives[29] and one convention[30] providing for the harmonization of particular aspects of the national tax laws. The reason why the harmonization is so sparse is that the Member States remain fiscally sovereign. The EC does not have original competence in the field of direct taxation.[31] If the EC nevertheless wants to remove tax obstacles to cross-border business activities which "directly affect the Internal Market", the Member States must reach a unanimous decision in the European Counil.[32] Since the harmonization of direct revenue, the Member States are reluctant to further harmonize the laws governing direct taxation.

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[26] See Arts. 3(1)(c) and 14(1) of the Treaty Establishing the European Community (EC Treaty).

[27] For these approaches, see Craig, P. and G. de Burca, *EU Law: Text, Cases, and Materials* (3rd ed., 2003), at 275 et seq.; Hinnekens, supra note 18, at 160 et seq.; and Streinz, R., *Europarecht* (7th ed., 2005), Para. 168 et seq.

[28] See Terra, B. and P. Wattel, *European Tax Law* (3rd ed., 2001), at 22 et seq.; and Arts. 249(2) and (3) of the EC Treaty.

[29] See Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, *OJ* L 336, 27 December 1977, at 15-27; Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfer of assets and exchanges of shares concerning companies of different Member States, *OJ* L 225, 20 August 1990, at 1-8; Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, *OJ* L 225, 22 September 1990, at 1-6; Council Directive 2001/44/EC of 15 June 2001 amending Directive 76/308/EEC on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund and of agricultural levies and customs duties and for value added tax and some excise duties, *OJ* L 175, 28 June 2001, at 17-20; Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, *OJ* L 157, 26 June 2003, at 38-48; and Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, *OJ* L 157, 26 June 2003, at 49-54.

[30] See Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, *OJ* L 225, 20 August 1990, at 10-24

[31] The field of indirect taxation is different; there, the EC is competent to provide for harmonization at the EC level (see Art. 93 of the EC Treaty).

[32] See Arts. 94 and 95(2) of the EC Treaty.

This situation is unsatisfactory considering the importance of tax laws, which may affect almost all forms of business activities and may impose significant burdens on cross-border activities in particular. The ECJ has therefore become the "integrative motor"[33] of the EC as regards direct taxation. The ECJ applies mainly the four fundamental freedoms, which constitute the internal market,[34] and the general non-discrimination rule.[35] The aim of the fundamental freedoms is to enable the optimal allocation of resources within the EC.[36] The problem with this form of integration, "negative integration,[37] is that its impact on direct taxation in the EC has been limited due to the nature of the ECJ as a court and the fundamental freedoms it applies. A court may rule only on the matters referred to it and may not take the initiative. Further, a court may consider only the particular case before it and may not establish a comprehensive system of tax law in a single decision if it is not required.[38] These two aspects together make the ECJ dependent on the cases referred to it. In addition, the fundamental freedoms to be applied by the ECJ in most tax cases cannot provide a complete harmonization of the national tax laws since the fundamental freedoms may only remove discrimination and restrictions.[39] Nevertheless, the case law of the ECJ has already had a far-reaching impact on the national tax laws. This has been

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[33] For this popular term characterizing the ECJ's role, see Birkenfeld, W., "Der Einfluß des Gemeinschaftsrechts auf die Rechtsverwirklichung im Steuerrecht Eine Bestandsaufnahme", 76 Steuer und Wirtschaft 55 (1998), at 75; Huber, P.M., in Streinz, R. (ed.), EUV/EGV: Vertrag über die Europäische Union und Vertrag zur Gründung der Europäischen Gemeinschaften (2003), Art. 220 EGV, note 4; Mössner, J.M., "Der EuGH als Steuergesetzgeber", 72 ASA/Archives 673 (2004), at 674; Rädler, A.J., "Recent Developments in European and International Taxation", 32 Intertax 365 (2004), at 366; and Schießl, H., "Europäisierung der deutschen Unternehmensbesteuerung durch den EuGH", 58 Neue Juristische Wochenschrift 849 (2005).

[34] See Arts. 14(2), 28, 39, 43, 49 and 56 of the EC Treaty.

[35] See Art. 12 of the EC Treaty.

[36] See e.g. Bizioli, G., "Impact of the freedom of establishment on tax law", 7 EC Tax Review 239 (1998), at 245 et seq.; Rödder, T. and J. Schönfeld, "Meistbegünstigung und EG-Recht: Anmerkung zu EuGH vom 5.7.2005, C-376/03 ('D')", 14 Internationales Steuerrecht 523 (2005), at 524 et seq.; Streinz, R., in Streinz (ed.), supra note 33, Art. 2 EGV, Para. 32; and von Bogdandy, A., in Grabitz, E. and M. Hilf (eds.), Das Recht der Europäischen Union (loose-leaf, June 2005), Art. 2 EGV, Paras. 37 and 42 et seq.

[37] See Hinnekens, supra note 18, at 149 et seq.; Pistone, P., "An EU Model Tax Convention", 11 EC Tax Review 129 (2002); and Terra and Wattel, supra note 28, at 22 et seq.

[38] The large number of decisions delivered in the field of tax law has, however, coalesced to a more or less self-contained system of "European tax law". Nevertheless, the national tax laws still contain many shortcomings regarding the establishment of a functioning internal market.

[39] See Cordewener, A., Europäische Grundfreiheiten und nationales Steuerrecht – "Konvergenz" des Gemeinschaftsrechts und "Kohärenz" der direkten Steuern in der Rechtsprechung des EuGH (2002), at 249 et seq. and 298 et seq.

appreciated,[40] but also heavily criticized.[41] The ECJ's supporters emphasize the importance of the fundamental freedoms for establishing the internal market,[42] requiring their application to the field of direct taxation even if the fundamental freedoms are general provisions that do not expressly refer to direct taxation. The opponents stress the Member States' fiscal sovereignty, which prevents the EC from influencing the national tax laws.[43] In the end, one should try to balance the two aspects in a way that honours both the aim of establishing a functioning internal market and the Member States' fiscal sovereignty.

The fundamental freedoms are not the only set of rules in the EC Treaty which may affect direct taxation. Because the EC lacks original competence in this field, the EC Treaty is generally silent on direct taxation. There is, however, one important exception.[44] The second indent of Art. 293 of the EC Treaty obliges the Member States to enter into negotiations with each other with a view to abolishing double taxation within the EC. It may be assumed that this provision is the key to determining the relationship between EC law and the tax treaties concluded among the Member States. However, the actual importance of this provision falls far behind expectations. In particular, it does not answer the question of MFN treatment.[45] First, Art. 293 is not directly applicable, i.e. the taxpayer may not claim a benefit on the basis of Art. 293 before the national courts.[46] Second, Art. 293 does not oblige the Member States to enter into an agreement.[47] It merely encourages them to abolish double taxation irrespective

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[40] See Schön, W., "Besteuerung im Binnenmarkt – die Rechtsprechung des EuGH zu den direkten Steuern", 13 Internationales Steuerrecht 289 (2004); Schuch, J., "Werden die Doppelbesteuerungsabkommen durch EURecht zu Meistbegünstigungsklauseln", in Gassner, W., M. Lang and E. Lechner (eds.), Doppelbesteuerungsabkommen und EU-Recht (1996), at 99, 108; and Schuch, J., "EC law requires multilateral tax treaty", 7 EC Tax Review 29 (1998), at 31.

[41] See Hey, J., "Perspektiven der Unternehmensbesteuerung in Europa", 81 Steuer und Wirtschaft 193 (2004); Lehner, M., "Limitation of the national power of taxation by the fundamental freedoms and non-discrimination clauses of the EC Treaty", 9 *EC Tax Review* 5 2000); Lehner, M., "Das Territorialitätsprinzip im Licht des Europarechts", in Gocke, R,. D. Gosch and M. Lang (eds.), *Körperschaftsteuer Internationales Steuerrecht Doppelbesteuerung: Festschrift für Franz Wassermeyer zum 65. Geburtstag* (2005), at 241; and Wieland, J., "Der Europäische Gerichtshof als Steuergesetzgeber?", in Gaitanides, C. and R. Bandilla (eds.) *Europa und seine Verfassung: Festschrift für Manfred Zuleeg zum siebzigsten Geburtstag* (2005), at 492.

[42] See Art. 14(2) of the EC Treaty.

[43] See Art. 5(1) of the EC Treaty.

[44] For more exceptions, see Avery Jones, J.F., "Flows of Capital between the EU and Third Countries and the Consequences of Disharmony in European International Tax Law", 7 *EC Tax Review* 95 (1998), at 96.

[45] Id. at 97.

[46] See Case C-336/96, *Mr and Mrs Robert Gilly v. Directeur des Services Fiscaux du Bas-Rhin*, [1988] ECR I-2793 (*Gilly*). The same applies to the other indents of Art. 293 of the EC Treaty. For the third indent (mutual recognition of companies, etc.), see e.g. the important *Daily Mail* decision: Case 81/87, *The Queen v. H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust PLC*, [1988] ECR 5483.

[47] See Kemmeren, E., "The termination of the 'most favoured nation' clause dispute in tax treaty law and the necessity of a Euro Model Tax Convention", 6 *EC Tax Review* 146 (1997), at 147; and Schuch, "Werden die Doppelbesteuerungsabkommen durch EU-Recht zu Meistbegünstigungsklauseln", supra note 40, at 133.

of the legal form of the measures.[48] The main objective of Art. 293 is to establish that the Member States are entitled to enter into tax treaties.[49] Art. 293 does not give any guidance on the substance of tax treaties.[50] Accordingly, the Member States are at liberty to negotiate the substance unless the superior EC law limits their freedom.

The fundamental freedoms may be one set of rules prevailing over tax treaties. Tax treaties may not generally be excluded from the scope of the fundamental freedoms,[51] although tax treaties are international law, not national law. The supremacy of EC law concerns mainly national law. Tax treaties as international agreements are usually made part of national law by way of implementing legislation.[52] Tax treaties may thus be considered to be national law for purposes of applying the fundamental freedoms. Even if tax treaties were not implemented into national law, EC law would have to take precedence because otherwise the Member States could use the legal form of tax treaties to circumvent their obligation to comply with EC law.[53] The special form of (in most cases) bilateral treaties, however, must be considered in applying the fundamental freedoms, in particular with regard to the justification of the restrictions on the fundamental freedoms.[54]

## 3.2 Tax treaties and MFN treatment under EC law

### 3.2.1 History

Tax treaties and MFN treatment under EC law is an issue of "European tax law" which has attracted much attention since the ECJ heard the *Schumacker* case in 1994. The

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[48] See Rädler, supra note 6, at 342.

[49] See Avery Jones, supra note 44, at 96; Eicker, K., "Tax Treaties and EC Law: Comment on the *Gilly* Case", 38 *European Taxation* 10 (1998), at 322, 323; and Teixera, G., "Tax Systems and Non-Discrimination in the European Union", 34 *Intertax* 50 (2005), at 51.

[50] See Avery Jones, supra note 44, at 96; Lang, M., "Doppelbesteuerungsabkommen und Gemeinschaftsrecht", in Breuninger, G., W. Müller and E. Haarmann-Strobl (eds.), *Steuerrecht und europäische Integration: Festschrift für Albert J. Rädler zum 65. Geburtstag* (1999), at 429, 437; and van der Linde, R., "Some thoughts on most-favoured nation treatment within the European Community legal order in pursuance of the *D* case", 13 *EC Tax Review* 10 (2004), at 14.

[51] See Case 270/83, *Commission of the European Communities v. French Republic*, [1986] ECR 273 (*Avoir Fiscal*). See also Farmer, supra note 4, at 139 et seq.; and Rädler, supra note 6, at 343 et seq.

[52] See Vogel, supra note 3, Introduction, Para. 40 et seq. From Germany's perspective, see e.g. Art. 59(2) of the Basic Law (*Grundgesetz*).

[53] See Art. 10 of the EC Treaty. If a tax treaty breaches EC law, the treaty is nevertheless valid, but not applicable. See Eicker, supra note 49, at 322; Hinnekens, supra note 18, at 162; and Vogel, supra note 3, Introduction, Para. 74 et seq.

[54] See Tietje, C., "Die Meistbegünstigungsverpflichtung im Gemeinschaftsrecht", 29 *Europarecht* 399 (1995), at 402 et seq. (correctly distinguishing between the competence to conclude (tax and other) treaties and the need for the treaties to comply with EC law). For the impact of the fundamental freedoms on the issue of MFN treatment regarding tax treaty benefits, see 3.2.; see also Kemmeren, supra note 47, at 146; and Rädler, A.J., "Most-Favoured-Nation Treatment in Direct Taxation – Some New Aspects", 13 *Steuer & Wirtschaft International* 360 (2003), at 361.

German Federal Tax Court (*Bundesfinanzhof* or BFH) had already dealt with this issue in 1990.[55] Without discussing the issue in depth, the BFH denied the existence of an MFN clause under EC law as regards tax treaty benefits. The BFH's decision met with virtually no response in academic writing. This was different with *Schumacker*, although the case did not give rise to the issue of MFN treatment. In the hearing, however, Judge Joliet asked whether the treatment of a taxpayer resident in Belgium by the German tax authorities would be more favourable if he were treated according to the Belgium-Netherlands tax treaty instead of the Germany-Netherlands tax treaty. The judge asked more or less directly whether EC law contains an MFN obligation regarding tax treaty benefits.[56] This comment was the seminal point for some academics to discuss in depth the issue of MFN treatment under EC law.[57] Despite the discussion of the issue at the hearing in *Schumacker*, the ECJ did not address the issue in its decision.[58] The reason may be that the issue was not relevant.[59] The ECJ pointed out, however, that the treatment of the Belgian resident would be different if he were resident in the Netherlands, but the ECJ did not make clear the purpose of this comment. In no way did the ECJ connect this comment to the issue of MFN treatment. The comment obviously supports the ECJ's reasoning regarding the need for the national treatment of Schumacker, which is actually a different issue.[60]

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55 Judgement of 31 October 10 1991, II R 167/87, (1991) *Bundessteuerblatt* II 161.

56 See Rädler, A.J., "EuGH: Mündliche Verhandlung im Fall *Schumacker* – Ehegattensplitting bei beschränkt steuerpflichtigen Grenzgängern", 76 *Finanz-Rundschau* 705 (1994), at 708.

57 See Rädler, A.J., "Fragen aus dem Schumacker-Urteil des EuGH", 50 *Betriebs-Berater* 793 (1995), at 795; Rädler, A.J., "Most-favoured-nation Clause in European Tax Law", 4 *EC Tax Review* 66 (1995); Schön, W., "Die beschränkte Steuerpflicht zwischen europäischem Gemeinschaftsrecht und deutschem Verfassungsrecht", 4 *Internationales Steuerrecht* 119 (1995), at 122 et seq.; Rädler, supra note 6, at 340 et seq.; Schuch, "Werden die Doppelbesteuerungsabkommen durch EU-Recht zu Meistbegünstigungsklauseln", supra note 40, at 99 et seq.; Schuch, J., "Die Reichweite der Diskriminierungsverbote des EG Vertrags Gilt im DBA-Recht die 'Meistbegünstigung'?", *Internationale Wirtschafts-Briefe* (1996), Fach 11, at 259; Schuch, J., "'Most-favoured-nation clause' in Tax Treaty Law", 5 *EC Tax Review* 161 (1996); Schuch, "EC law requires multilateral tax treaty", supra note 40; Wassermeyer, F., "Die Vermeidung der Doppelbesteuerung im Europäischen Binnenmarkt", in Lehner, M., *Veröffentlichungen der Deutschen Steuerjuristischen Gesellschaft 19: Steuerrecht im Europäischen Binnenmarkt – Einfluss des EG-Rechts auf die nationalen Steuerrechtsordnungen* (1996), at 151, 162 et seq.

58 See Case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker*, [1995] ECR I-225. By contrast, in his opinion delivered on 22 November 1994, the Advocate-General discussed the issue of MFN treatment and found that the denial of MFN treatment would breach EC law.

59 The ECJ decided that Germany unlawfully discriminated against the Belgian resident (Schumacker) by not treating him as a resident of Germany. Since he generated more than 90% of his income in Germany, he was – although a non-resident – in a situation comparable to a resident of Germany. Accordingly, the fundamental freedoms required Germany to treat Schumacker as a resident; thus, the issue of equal treatment of non-residents from another Member State did not arise.

60 See Thömmes, O., "EG-rechtliches Meistbegünstigungsprinzip", in *Jahrbuch der Fachanwälte für Steuerrecht 1995/96* (1996), at 64 et seq.; Tietje, supra note 54, at 400 et seq.

In the aftermath, the ECJ also refrained from deciding the issue in the *Saint-Gobain* and *Hoechst and Metallgesellschaft* cases for the same reason (i.e. lack of relevance).[61] Interestingly, the issue of MFN treatment was explicitly referred to the ECJ in the preliminary proceeding in *Hoechst and Metallgesellschaft*, whereas in *Saint-Gobain* (as in *Schumacker*) only the facts could be interpreted in such a way as to make the issue relevant to the decision.[62]

### 3.2.2 The "*D*" case – facts and decision

In the "*D*" case,[63] the ECJ had another opportunity to deal with the issue and used the opportunity. In that case, the taxpayer D was resident in Germany; 10% of his wealth/property was located in the Netherlands and 90% in Germany. The crucial point was that the Netherlands levies a wealth tax but Germany does not. Accordingly, D was subject to the wealth tax only in the Netherlands on his wealth located there. Relying on EC law,[64] D applied in the Netherlands for the deduction of the personal allowance which, under the Dutch wealth tax law, was available only to residents or to non-residents holding at least 90% of their wealth in the Netherlands. Alternatively, D claimed that he should be treated under the Belgium–Netherlands tax treaty, which extends the allowance to taxpayers resident in Belgium; in contrast, the Germany–Netherlands tax treaty does not grant such a benefit to residents of Germany. The

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[61] See Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, [1999] ECR I-6161; Joined Cases C-397/03 and C-410/03, Metallgesellschaft Ltd and others (C-397/98), Hoechst AG, Hoechst (UK) Ltd v. Commissioners of Inland Revenue, HM Attorney General (C-410/98), [2001] ECR I-1727. In Saint-Gobain, the ECJ held that the Member States must treat a permanent establishment (PE) of a company resident in another Member State like a subsidiary. Accordingly, a company must – unlike otherwise (see Farmer, supra note 4, at 138) – be granted the benefits in the tax treaties with third (Member) States with respect to a PE if the benefits were granted to a subsidiary (i.e. a resident). In the end, the decision requires that the tax consequences not depend on the legal form. The issue of MFN treatment would have arisen if the tax treaty between the Member State in which the PE was located and another (Member) State had granted a treaty benefit to a PE of a company resident in the latter (Member) State. In Hoechst and Metallgesellschaft, the issue was whether a Member State may, consistent with the EC Treaty, allow a subsidiary to exercise an option that may reduce the tax burden only if the parent is a resident of that Member State. The ECJ clearly decided that a Member State breaches the fundamental freedoms if it makes the exercise of a favourable option subject to the parent being a resident of the same Member State. Accordingly, the ECJ did not need to decide whether a subsidiary may claim that some tax treaties with third (Member) States offer subsidiaries of companies resident in those (Member) States the option, which is usually available only to subsidiaries whose parent is resident in the respective Member State.

[62] For comments on these decisions, see Dourado, A.P., "From the *Saint-Gobain* to the *Metallgesellschaft* case: the scope of non-discrimination of permanent establishments in the EC Treaty and the most-favoured-nation clause in EC Member States tax treaties", 11 *EC Tax Review* 147 (2002).

[63] See note 2, supra. For a comprehensive discussion of this case, see Weber, D., "Most-Favoured-Nation Treatment under Tax Treaties Rejected in the European Community: Background and Analysis of the *D* Case – A proposal to include a most-favoured-nation clause in the EC Treaty", 33 *Intertax* 429 (2005).

[64] In particular, D relied on *Schumacker* (see note 58, supra), in which the ECJ held that a non-resident is in a situation comparable to a resident if he generates 90% or more of his income in the Member State in which he is a non-resident. Thus, that Member State must consider the taxpayer's personal situation just as it does for its resident taxpayers and must allow the deduction of personal allowances.

Dutch tax authorities denied D the deduction of the personal allowance. D brought an action before the competent Dutch court, which referred the matter to the ECJ and asked for a preliminary ruling on several questions. The first question was whether EC law requires the Netherlands to allow a non-resident taxpayer all of whose "taxable wealth"[65] is located in the Netherlands to deduct the personal allowance to which a resident is entitled. Alternatively, the question was whether the Dutch tax authorities were obliged to afford MFN treatment if the Belgium-Netherlands tax treaty was more favourable to residents of Belgium, i.e. it allowed the deduction of the personal allowance.[66]

In his opinion of 26 October 2004, the Advocate-General concluded that the fundamental freedoms required the Dutch tax authorities to treat D as a resident of the Netherlands for Dutch wealth tax purposes regarding his wealth located in the Netherlands. Accordingly, D was entitled to the deduction of the personal allowance that was available to residents of the Netherlands. Since this issue was preliminary to the issue of MFN treatment, the latter issue did not arise. The Advocate-General nevertheless discussed the MFN treatment issue and found that a Member State breaches the fundamental freedoms of the EC Treaty if it does not grant a non-resident taxpayer the tax treaty benefit which it grants to a non-resident from a third Member State.

The ECJ disagreed and held that a Member State does not breach EC law if it does not grant MFN treatment to non-resident taxpayers. The ECJ's decision came as a surprise since the ECJ usually follows the Advocate-General's opinion.[67] In the "*D*" case, the ECJ decided differently not only on the preliminary issue (i.e. requirement to treat D as a resident),[68] but also on the MFN treatment issue.[69]

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[65] Since Germany does not levy a wealth tax but the Netherlands does, D was subject to the wealth tax in the Netherlands only on his wealth located there. Accordingly, all of his "taxable wealth" was subject to the wealth tax in the Netherlands.

[66] For the sake of completeness, the Dutch court also asked whether the treatment of legal costs in proceedings regarding the breach of EC law complies with EC law. This question was not answered because it was asked only if either of the previous two questions was answered in the affirmative. As discussed below, both were answered in the negative.

[67] See Hofbauer, I., "Erfordern die Grundfreiheiten des EG-V eine innereuropäische Meistbegünstigung? – Erste Erkenntnisse aus dem 'D'-Fall", 14 *Steuer & Wirtschaft International* 586 (2004), at 589 et seq.; and Kraft and Robra, supra note 15, at 252.

[68] In its decision, the ECJ confirmed the "*Schumacker* doctrine" established in *Schumacker* (see note 58, supra), i.e. that the decisive aspect is how much of the wealth is located (in *Schumacker*: the income is generated) in the Member States concerned. The fact that the wealth (income) is not taxable does not matter. Accordingly, the ECJ ruled that the Netherlands need not treat D as a resident since only 10% of his wealth was located in the Netherlands. Commentators on the decision in the "*D*" case have heavily criticized this confirmation of the *Schumacker* doctrine.

[69] The Advocate-General in principle relied on the same argument as the ECJ (i.e. reciprocity), but did not qualify the respective provision of the Belgium–Netherlands tax treaty based on reciprocity since Belgium

### 3.2.3 Analysis of the decision in the "*D*" case

The decision in the "*D*" case was long expected. If the ECJ had decided in favour of an MFN treatment obligation, the consequences for a Member State's tax treaty network would have been far-reaching. The tax treaties concluded among the Member States – and possibly also those concluded between the Member States and third states – would have been harmonized. Since the harmonization would have occurred at the level of the most favourable tax treatment of a non-resident taxpayer,[70] the public revenue of the Member States would have been severely affected. The tax consequences of cross-border business activities might have had to be determined according to any of the many tax treaties concluded with the other Member States. Reliable financial budgeting would no longer have been possible.[71] This is one reason why some authors have proposed that a multilateral tax treaty be concluded[72] or that an EC Model Tax Convention be adopted.[73] From the taxpayer's perspective, the decision was disappointing[74] because the opposite decision could have resulted in new tax planning options and a lower tax burden.

Although the result of the decision in the "*D*" case and its effects on the Member States and taxpayers are clear, the ECJ's reasoning does not provide a comprehensive discussion of the issue. It is particularly surprising that the decision does not follow the classical pattern according to which the compliance of a Member State's measure with the fundamental freedoms is examined. The decision confuses the scope of the fundamental freedoms and the justification of discrimination or restriction.[75] The two should

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does not levy a wealth tax. Accordingly, the benefit granted by the Netherlands was unilateral. In contrast, the ECJ considered even such a benefit to be an integral part of the tax treaty; thus, it is based on reciprocity.

70 See Kemmeren, supra note 9, at 257; Pistone, supra note 7, at 210; Schön, supra note 57, at 122 et seq. For other consequences, see Dourado, supra note 62, at 151 et seq.; and Kemmeren, supra note 47, at 148 et seq. In Lehner, M., "Der Einfluss des Europarechts auf die Doppelbesteuerungsabkommen", 10 *Internationales Steuerrecht* 329 (2001), at 336, the author speaks of "*gemeinschaftsrechtlich sanktionierte[s]* [EC law-sanctioned] treaty shopping".

71 See Hinnekens, supra note 18, at 154; Hofbauer, "Most-Favoured-Nation Clauses in Double Taxation Agreements – A Worldwide Overview", supra note 7, at 449; and Vogel, K., "Problems of a Most-Favoured-Nation Clause in Intra-EU Treaty Law", 4 *EC Tax Review* 264 (1995).

72 A multilateral tax treaty among the Member States would be based on Art. 293 of the EC Treaty. See e.g. Rädler, supra note 54, at 362; Schuch, "EC law requires multilateral tax treaty", supra note 40, at 36 et seq.; and Wassermeyer, F., "Zwingt die Rechtsentwicklung zum Abschluß multilateraler Abkommen?", 51 *Der Betrieb* 28 (1998), at 33. To the extent possible, the treaty would be modelled on the OECD Model. See Lang, supra note 50, at 439 et seq.

73 An EC Model Tax Convention would also be modelled on the OECD Model, but it would be amended so as to comply with EC law. See e.g. Kemmeren, supra note 47, at 149 et seq.; and Pistone, supra note 37.

74 See Thömmes, O., "Anmerkung", *Internationale Wirtschafts-Briefe* (2005), Fach 11a, at 887, 887; and Weggenmann, H., "RIW-Kommentar", 51 *Recht der Internationalen Wirtschaft* 717 (2005), at 717 and 720.

75 See Pistone, P., "National Treatment for All Non-resident EU Nationals: Looking Beyond the *D* Decision", 33 *Intertax* 412 (2005); van Thiel, S., "A Slip of the European Court in the *D* Case (C-376/03): Denial of the Most-Favoured-Nation Treatment because of Absence of Similarity?", 33 *Intertax* 454 (2005), at 455; Weggenmann, supra note 74, at 718 et seq. For an Austrian case in which an administrative body denied discrimi-

be considered separately. The fundamental freedoms were intended to abolish discrimination against those engaged in cross-border business activities. Over the years, the fundamental freedoms have evolved from a pure non-discrimination clause to a non-restriction clause.[76] Although the latter feature of the fundamental freedoms has become of major relevance in recent years since overt discrimination is obvious and no Member State wants to be accused of it, the issue of MFN treatment is a classical case of discrimination. A non-resident taxpayer complains that he is treated less favourably than another non-resident taxpayer who is resident in a third (Member) State.

The fundamental freedoms apply only to the nationals of the Member States.[77] One must therefore examine whether a Member State treats the nationals of another Member State differently. It is important to note that the tax law uses different connecting factors. The liability to tax usually depends on the taxpayer's residence, not his nationality, or on the location of the source of the income/location of the wealth. Discrimination in the context of taxation is therefore usually a "covert discrimination", which is also covered by the fundamental freedoms.[78] Since this part of the article deals with the impact of EC law on tax treaties, the comments below refer to residents and non-residents instead of nationals and non-nationals. One must, however, bear in mind that the fundamental freedoms improve the situation of a resident/non-resident only if he is a national of a Member State (not necessarily a national of the residence state). For purposes of this article, it is assumed that the nationals of a Member State are resident in the Member State of nationality and non-nationals are non-resident in that Member State.

Determining discrimination requires a pair of comparable situations which are treated differently. There are three scenarios that may establish discrimination. The first is the

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nation for dubious reasons, see Hofbauer, I., "UFS verneint die Geltung der Meistbegünstigung", 15 *Steuer & Wirtschaft International* 376 (2005).

[76] See Cordewener, supra note 39, at 103 et seq. and 200 et seq.; Farmer, supra note 4, at 142 et seq.; and Terra and Wattel, supra note 28, at 41 et seq. It is important to note that the free movement of capital exceptionally also applies with respect to business activities in which third countries are involved.

[77] See Arts. 28, 39, 43, 49 and 56 of the EC Treaty.

[78] See Case C-355/98, *Commission v. Belgium*, [2000] ECR I-1221. See also Avery Jones, supra note 44, at 99 et seq.; Cordewener, supra note 39, at 103 et seq.; Craig and de Burca, supra note 27; Farmer, P. and R. Lyal, *EC Tax Law* (1994), at 312; Farmer, P., "EC Law and Direct Taxation – Some Thoughts on Recent Issues", 1 *EC Tax Journal* 91 (1995/96), at 93; Herzig, N. and N. Dautzenberg, "Der EWG-Vertrag und die Doppelbesteuerungsabkommen – Rechtsfragen im Verhältnis zwischen Doppelbesteuerungsabkommen und den Diskriminierungsverboten des EWGV", 47 *Der Betrieb* 2519 (1992), at 2521; Hinnekens, L., "Non-Discrimination in EC Income Tax Law: Painting in the Colours of a Chameleon-Like Principle", 36 *European Taxation* 9 (1996), at 286, 294 et seq.; Terra and Wattel, supra note 28, at 41 et seq.; and van der Linde, supra note 50, at 11. It is important to note that covert discrimination may also be considered as a restriction. According to the current dogmatic status of the fundamental freedoms, the distinction does not matter. See further below.

classical discrimination of a non-resident vis-à-vis a resident,[79] where the question is whether a resident taxpayer and a non-resident taxpayer are in a comparable situation. The resident taxpayer normally has a closer link to the residence state than the non-resident taxpayer. Basically, the residence state is in the best position to consider the taxpayer's personal situation. In contrast, the personal situation of the non-resident taxpayer cannot be appropriately considered by the source state. Therefore, resident and non-resident taxpayers are in a different situation. Second, one may compare two residents, one of whom is engaged in cross-border business activities.[80] Here, the question is whether the fundamental freedoms in their capacity as a non-discrimination clause apply. Initially, the fundamental freedoms intended only to provide national treatment for non-nationals (non-residents). However, the fundamental freedoms undoubtedly also prohibit the Member States from discriminating against the outbound activities of residents.[81] Such activities may also contribute to the optimal allocation of resources within the EC which the fundamental freedoms facilitate. Accordingly, a taxpayer engaged in cross-border business activities is usually in a situation comparable to a taxpayer who is not engaged in such activities.

Finally, one may ask whether two non-residents from different Member States are in a comparable situation. This is the situation underlying the MFN treatment issue. Considering that the intention of fundamental freedoms is to enable the optimal allocation of resources within the EC, it may be argued that a Member State also breaches the fundamental freedoms if it treats non-residents from different Member States who are engaged in activities in the first Member State differently.[82] The non-residents are engaged in activities in the same Member State and are therefore in a comparable situation.[83] This argument has some merit against the background of establishing an internal market, which is the aim of the EC.[84] However, the question is whether the funda-

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[79] See e.g. the *Avoir Fiscal* case, supra note 51; Case C-3330/91, *The Queen/Inland Revenue Commissioners, Ex Parte Commerzbank AG*, [1993] ECR I-4017; and the *Schumacker* case, supra note 58.

[80] See e.g. Case C-175/88, Klaus Biehl/Administration Des Contributions [1990] ECR I-1779 (Biehl); Case C-204/90, Hanns-Martin Bachmann/Belgian State, [1992] ECR I-249 (Bachmann); and Case C-1/93, Halliburton Services BV/Staatssecretaris van Financiën, [1994] ECR I-1137.

[81] Whether this situation constitutes discrimination or rather a restriction is subject to debate, particularly in academic writing. The ECJ has not distinguished between these two forms of interference with the fundamental freedoms in its recent decisions in the field of taxation. See the *Daily Mail* case, supra note 46; and Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, [2004] ECR I-2409 (*de Lasteyrie*). See also Cordewener, supra note 39, at 200 et seq.; Craig and de Burca, supra note 27, at 787 et seq.; Hinnekens, supra note 78, at 295 et seq.; and Terra and Wattel, supra note 28, at 43 et seq.

[82] See e.g. Herzig and Dautzenberg, supra note 78, at 2521 et seq.; Hofbauer, supra note 67, at 590; Pistone, supra note 7, at 21; Rädler, supra note 54; and Weggenmann, supra note 1, at 679.

[83] Van der Linde, supra note 50, at 13; and Weggenmann, supra note 74, at 718 et seq.

[84] See Lang, supra note 50, at 433; and van Thiel, supra note 75, at 455.

mental freedoms should be interpreted so broadly. This is doubtful since the wording of the individual fundamental freedoms is different. The free movement of workers (Art. 39 of the EC Treaty) and the free movement of capital (Art. 56) prohibit "any discrimination" (Art. 39) and "all restrictions" (Art. 56) on grounds of nationality; in contrast, the freedom of establishment (Art. 43) and the freedom to provide services (Art. 49) require only national treatment, i.e. the Member States must treat non-residents according to the provisions applicable to residents.[85] For the issue of MFN treatment, the conclusion might be that only cross-border activities covered by the free movement of workers or the free movement of capital qualify for MFN treatment. Cross-border business activities that fall under the freedom of establishment or the freedom to provide services are not eligible for MFN treatment.

Although the "*D*" case concerned the free movement of capital, whose wording would cover an MFN treatment obligation, the question whether the general nondiscrimination clause (Art. 12 of the EC Treaty) applies to cases falling under the freedom of establishment or the freedom to provide services is discussed because it is of fundamental importance to the issue of MFN treatment in the field of direct taxation. The general non-discrimination clause also prohibits "any discrimination" on grounds of nationality.[86] Applying the general non-discrimination clause would result in an MFN obligation even in situations where the wording of the individual fundamental freedoms appears not to provide protection to residents of third Member States. Accordingly, one needs to consider the relationship between the general non-discrimination clause and the individual fundamental freedoms.

In principle, two views are conceivable. First, the individual fundamental freedoms may be considered as *leges speciales* which exclude the general non-discrimination clause as *lex generalis*.[87] The opposite view is that the individual fundamental freedoms are special types of discrimination which are codified only for the sake of simplification. According this view, the fundamental freedoms do not exclude the application of the general non-discrimination clause if the situation is principally covered by the individual fundamental freedoms, but lacks a particular requirement of the funda-

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[85] For this scope of these two fundamental freedoms if they are considered separately from the other fundamental freedoms and the general nondiscrimination clause, see Weggenmann, supra note 1, at 679. The free movement of goods (Art. 28 of the EC Treaty) also covers "any discrimination and restriction", but Art. 28 is not of major relevance to direct taxation.

[86] See Tietje, supra note 54, at 411 et seq.; van der Linde, supra note 50, at 13; and Weber, D. and E. Spierts, "The '*D* Case': Most-Favoured-Nation Treatment and Compensation of Legal Costs before the European Court of Justice", 44 *European Taxation* 2/3 (2004), at 65, 68.

[87] See Herzig and Dautzenberg, supra note 78, at 2522; and Weggenmann, supra note 1, at 680.

mental freedom at issue.[88] The latter view is preferable. Given the purpose of the fundamental freedoms (i.e. the optimal allocation of resources within the EC), a teleological interpretation must give the fundamental freedoms the most far-reaching scope. Since establishing a functioning internal market is the main goal of the EC (see 3.1.), a teleological interpretation must prevail over a systematic interpretation, which could (but does not necessarily) result in excluding the general non-discrimination clause if the situation falls under the individual fundamental freedoms.

One might wonder why the scope of the individual fundamental freedoms differs. The Member States might have intended to give the fundamental freedoms a different scope,[89] but this begs the question. For example, workers under the free movement of workers are treated differently from self-employed persons under the freedom of establishment, although both fundamental freedoms aim at the optimal allocation of the human factor. The freedom of establishment protecting self-employed persons, however, also covers the optimal allocation of the capital necessary to conduct business, but this difference does not justify a different treatment. The mere transfer of capital is covered by the free movement of capital, which, according to the relevant provision of the EC Treaty, prohibits "all restrictions" on grounds of nationality. Accordingly, the capital component included in the freedom of establishment should not restrict the scope of that fundamental freedom vis-à-vis the scope of the free movement of workers.[90] Furthermore, delimiting the individual fundamental freedoms against each other is sometimes very difficult. The distinction between workers and self-employed persons or between establishing a business and the transfer of capital may not be clear. Defining the scope of different rules is a general legal problem, and difficulties in this respect may not generally be resolved by assuming that these rules have the same scope. The situation is different with the fundamental freedoms. There is a clear intention to facilitate the establishment of a functioning internal market, and this justifies interpreting the fundamental freedoms in such a way that the legal consequences are identical. In addition, it appears that the fundamental freedoms were not drafted carefully. Some of them are phrased only as a non-discrimination clause (Arts. 28 and 43

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[88] See Farmer and Lyal, supra note 78, at 310 et seq.; Schuch, "Werden die Doppelbesteuerungsabkommen durch EU-Recht zu Meistbegünstigungsklauseln", supra note 40, at 120 et seq.; and Schuch, "EC law requires multilateral tax treaty", supra note 40, at 33 et seq.

[89] See Weggenmann, supra note 1, at 680.

[90] The freedom of establishment protects only cross-border transactions which facilitate controlling the business, whereas the free movement of capital does not require such a far-reaching impact on the business, but this fact also does not justify a different scope of the fundamental freedoms. The only reason for a Member State to deliberately treat the fundamental freedoms differently in this way might be to protect its economy from a significant foreign influence. This form of protectionism contravenes the idea of the fundamental freedoms; thus, it should not be decisive for interpreting the fundamental freedoms.

of the EC Treaty), whereas others also include non-restriction provisions (Arts. 39, 49 and 56). In this regard, there is no doubt that all the fundamental freedoms prohibit both discrimination and restriction even if the wording does not go so far.[91] Therefore, the wording should not be overestimated, although the wording of a legal provision is important for its interpretation.

Each of the fundamental freedoms in principle contains an MFN obligation. If none of the fundamental freedoms applies, the general non-discrimination clause provides the MFN obligation. This result is not affected by the Member States' competence to conclude tax treaties. This competence cannot exclude the comparability of non-residents from different Member States. Although the Member States continue to be fiscally sovereign and the second indent of Art. 293 of the EC Treaty confirms their power to conclude tax treaties, tax treaties must comply with EC law. No one – not the EC, the Member States or persons engaged in cross-border business activities within the EC – should want a formalistic handling of the Members States' fiscal sovereignty since the far-reaching tax consequences on cross-border business activities could severely impede such activities. Nevertheless, the Member States' fiscal sovereignty must be observed, but it may not result in tax obstacles that are unnecessary to protect the Member States' fiscal interests. Even if the Member States have sovereignty in a particular area, it may be expected that they will exercise their power in a way that does not hinder achieving the aim of the EC.[92] This requires an appreciation of values which can best be done by considering the potential justification of discrimination or restriction. At that level, one may consider whether the Member States' fiscal sovereignty may justify discrimination or restriction in a particular case. The ECJ's solution to exclude MFN situations from the scope of the fundamental freedoms is not an appropriate way to balance the Member States' fiscal sovereignty and the aim of establishing an internal market. The mere determination of discrimination/restriction cannot achieve balancing the counteracting aspects.[93]

From this perspective, the ECJ's reasoning in the "*D*" case is inconsistent. The ECJ rightly said that the Member States' power to conclude tax treaties with other states, including the Member States, may have the result of different rules being applicable to

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[91] See Cordewener, supra note 39, at 249 et seq.; Craig and de Burca, supra note 27, at 783 et seq.; and Terra and Wattel, supra note 28, at 41 et seq.

[92] See Art. 10 of the EC Treaty, which contains the principle of Community loyalty. For the principle of Community loyalty in respect of direct taxes, see generally Hinnekens, supra note 18, at 148 et seq.

[93] This view may not result in the conclusion that levying taxes requires a justification in every case. Levying taxes does not constitute discrimination or restriction if the taxes do not directly or indirectly provide a different tax treatment for cross-border activities because of their cross-border character.

nonresidents from different states (Member States). But the conclusion that non-residents from different Member States were therefore not in a comparable situation, excluding discrimination, is misleading. The issue is whether the Member States unlawfully discriminate against non-residents if the tax treaties applicable to non-residents from the other Member States are more favourable.[94] The ECJ, however, denied that non-residents from different Member States are in a comparable situation (which is a requirement of discrimination and therefore a preliminary issue for MFN treatment) by answering the issue (i.e. the legality of tax treaties with differing provisions for non-residents from different Member States, which is the MFN issue) in the negative.[95] The ECJ's view stressed the Member States' fiscal sovereignty, but as the ECJ itself has regularly pointed out, the Member States must, despite their fiscal sovereignty, comply with EC law.[96] Therefore, one must wonder why the ECJ considered that the conclusion of tax treaties is excluded from the scope of the fundamental freedoms without a comprehensive discussion.

Because of the view taken above, i.e. that EC law (in particular, the fundamental freedoms) contains an MFN obligation, it must be examined whether the differing tax treaty benefits available to non-residents from different Member States may be justified.[97] In the past, it was important to distinguish between discrimination and restriction. Depending on the form of interference with the fundamental freedoms, the requirements for justification varied. Discrimination could be justified only on the basis of reasons expressly mentioned in the EC Treaty (Arts. 30, 39(3), 46, 55 and 58) and restrictions only on grounds of the public interest, which usually could not be specifically found in the EC Treaty.[98] The distinction between discrimination and restriction has lost much of its importance, and the ECJ often does not distinguish between the two.[99] Consequently, the distinction may also no longer be relevant at the justification level. Any discrimination and any restriction may be justified on the basis of reasons

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[94] See Wolvers, supra note 9, at 256 (comments of D. Weber, who had countered this view even before the ECJ delivered its decision in the "*D*" case). See also Kofler, G.W. and C.P. Schindler, "'Dancing with Mr D': The ECJ's Denial of Most-Favoured-Nation Treatment in the '*D*' case", 45 *European Taxation* 12 (2005), at 530, 537 et seq.; and Weggenmann, supra note 74, at 718 et seq.

[95] See Farmer, supra note 78, at 103 (taking the same position as the ECJ).

[96] See e.g. *Biehl* and *Bachmann*, both supra note 80; *Schumacker*, supra note 58; Case C-80/94, *G-H.E.J. Wielockx v. Inspecteur der directe belastingen*, [1995] ECR I-2493 (*Wielockx*); *Gilly*, supra note 46; *Saint-Gobain*, supra note 61; and *de Lasteyrie*, supra note 81.

[97] See van der Linde, supra note 50, at 14 et seq. (agreeing with the above view; also wanting to give the fundamental freedoms in principle a far-reaching effect and considering reciprocity as a possible justification).

[98] See e.g. Case C-175/88, *Klaus Biehl/Administration Des Contributions*, [1990] ECR I-1779.

[99] See e.g. *Daily Mail*, supra note 46; and *de Lasteyrie*, supra note 81. See also Farmer, supra note 4, at 144 and 147.

expressly mentioned in the EC Treaty as well as on the basis of the public interest, which is not contained in the provisions codifying the fundamental freedoms.[100]

The ECJ is regularly confronted with a large number of justifications made by the Member States in cases involving direct taxation. The ECJ, however, is very restrictive in accepting the reasons that will justify an interference with the fundamental freedoms.[101] The ECJ has generally rejected, as a valid reason justifying discrimination or restriction, a decrease in revenue, the non-harmonization of the laws regulating direct taxation, and the compensation of a disadvantage by another benefit. In principle, the ECJ has recognized the effectiveness of fiscal supervision and the prevention of abuse as valid reasons that justify discrimination or restriction, but the ECJ did not allow these reasons to apply in an actual case for long.[102] It seems that the ECJ took a new position on this justification in the *Marks & Spencer* decision.[103] The only justifications consistently approved generally and in a particular case have been fiscal cohesion[104] and the territoriality principle.[105] Fiscal cohesion means the integrity of a tax system which must be safeguarded by discriminatory or restrictive provisions. The fiscal cohesion justification ensures the equality of taxation within a Member State. The ECJ was very restrictive in applying the fiscal cohesion justification before the *Marks & Spencer* decision and acknowledged it only once – in the *Bachmann* decision.[106] The same is true with the territoriality principle, which was recognized in the *Futura* decision.[107] According to this principle, the Member States may deny tax benefits which are not related to their territory. None of the justifications referred to here is of particular interest in the context of tax treaties; thus, they are not considered further.

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[100] See e.g. *Biehl* and *Bachmann*, both supra note 80. See also Cordewener, supra note 39, at 142 et seq.; Farmer, supra note 78, at 95 et seq.; Hinnekens, supra note 78, at 300 et seq.; and Terra and Wattel, supra note 28, at 43.

[101] For an overview of possible justifications, see e.g. Cordewener, supra note 39, at 926 et seq.; and Terra and Wattel, supra note 28, at 63 et seq.

[102] Regarding fiscal supervision, the ECJ refers to secondary EC law which facilitates mutual assistance between the Member States, namely, Council Directives 77/799/EEC and 2001/44/EC, both supra note 29. Accordingly, fiscal supervision no longer constitutes a justification for discrimination or restriction. The prevention of abuse may only be tackled on a case-by-case basis, not by general rules also applicable to those acting in good faith. See e.g. *de Lasteyrie*, supra note 81.

[103] Case C-446/03, *Marks & Spencer plc/David Halsey (Her Majesty's Inspector of Taxes)*, ECJ judgement of 13 December 2005 (not yet reported).

[104] See *Bachmann*, supra note 80. See also Cordewener, supra note 39, at 958 et seq.; and Terra and Wattel, supra note 28, at 63 et seq.

[105] See Case C-250/95, Futura Participations SA und Singer/Administration des Contributions, [1997] ECR I-2471 (Futura).

[106] *Bachmann*, supra note 80. To be accurate, the ECJ also recognized fiscal cohesion in Case C-300/90, *Commission of the European Communities v. Belgium*, [1992] ECR I-305, but it was similar to *Bachmann*. In the *Marks and Spencer* decision (supra note 103), the ECJ did not expressly mention the word "cohesion". Nevertheless, it may be assumed that the ECJ will accept the "cohesion" justification in more cases in the future since the ECJ now follows an approach that is more friendly to the Member States at the justification level.

[107] See *Futura*, supra note 105; and *Marks & Spencer*, supra note 103.

There is, however, one justification which is of major relevance when discussing the relationship between EC law and tax treaties. The Member States sometimes try to justify discrimination or restriction by reference to their obligations under tax treaties. The ECJ regularly denies this justification. According to the ECJ, a Member State may not safeguard the fiscal cohesion of its national tax system by discriminatory or restrictive provisions if, by way of a tax treaty, the Member State has given up some of its taxing rights to another Member State.[108] According to this case law, the Member States are free to allocate their taxing rights as they see fit, but they may not exercise the taxing rights allocated to them in a discriminatory way, i.e. once the Member States have allocated the taxing rights, they must treat non-residents in the same way as residents if the non-residents are in a comparable situation.[109] This is true irrespective of the legal form of the discriminatory measure. Therefore, even if the Member States exercise their taxing rights by way of tax treaties, they may breach EC law. The exercise of taxing rights in this respect means that the Member States should negotiate the substantive provisions of tax treaties, not only the provisions allocating their taxing rights.[110] The denial of justification on grounds of tax treaties in such cases, however, does not mean that tax treaties generally cannot justify an interference with the fundamental freedoms. The decision in the "*D*" case shows that even the ECJ regards tax treaties as a legal means which may prevail over the fundamental freedoms, albeit this conclusion was not reached at the justification level, but in the course of determining the existence of discrimination. See below.

The ECJ's key argument for the lawfulness of differing tax treaty benefits for non-residents from different Member States was the reciprocity of provisions contained in (bilateral) tax treaties.[111] This argument is valid. According to the view taken above, however, the reciprocity of tax treaty provisions may constitute a justification, but this justification needs more clarification. The mere reference to the reciprocity of tax

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[108] See e.g. *Avoir Fiscal*, supra note 51; *Wielockx*, supra note 96; *Gilly*, supra note 46; and *Saint-Gobain*, supra note 61.

[109] See Farmer, supra note 4, at 150 et seq.

[110] It may, however, be difficult to draw the line between the two categories of rules. See Wolvers, supra note 9, at 258 (comments of A. Cordewener) and 257 (comments of F. Engelen). For an attempt to draw such a line, see Dourado, supra note 62, at 153 et seq.

[111] The ECJ acknowledged the reciprocity argument in *Gottardo* (Case C-55/00, *Elide Gottardo v. Istituto nazionale della previdenza sociale (INPS)*, [2002] ECR I-413). For various reasons, however, this decision cannot be applied to bilateral tax treaties. The *Gottardo* case concerned (a) social security law, (b) national treatment instead of MFN treatment, and (c) bilateral agreements with non-EU countries. See Pistone, supra note 75, at 413 (saying that these differences are relevant). But see van der Linde, supra note 50, at 15 (applying this decision to the MFN treatment situation as regards tax treaty benefits). See Schnitger, A., "§ 20 Abs. 2 und 3 AStG a.F. vor dem EuGH – Meistbegtünstigung 'Reloaded'?", 87 *Finanz-Rundschau* 1079 (2005), at 1082 et seq. (discussing the MFN treatment obligation if benefits are granted unilaterally by the national tax laws).

treaty provisions in itself does not make it clear why such reciprocity is appropriate to justify discrimination. The reason for the importance of the reciprocity of bilateral tax treaties as a possible justification is the Member States' fiscal sovereignty. Fiscal sovereignty is the actual reason for all potential grounds of justification for discrimination or restriction in the field of tax law. The reasons regularly given by the Member States are only specific aspects of their fiscal sovereignty. Their fiscal sovereignty must therefore take a prominent role in determining the capacity of possible justifications in the field of direct taxation.[112] The Member States' fiscal sovereignty is not expressly mentioned in the provisions containing the reasons that justify discrimination. Pursuant to the current dogmatic status of the fundamental freedoms outlined above, this does not matter because even discrimination may be justified on grounds not expressly mentioned in the provisions codifying the fundamental freedoms.[113] Accordingly, any reason of the public interest may serve as a justification. The Member States' fiscal sovereignty is, in every case, a very strong public interest. Public revenue is of great importance to the Member States. This is reflected particularly in the unanimity principle in the EC Treaty, which applies to legislative measures in the field of direct taxation.[114] Since neither the guarantee of the fundamental freedoms nor the Member States' fiscal sovereignty prevails automatically, the two must be balanced.[115] This can best be achieved by applying the proportionality principle.[116] Thus, the question is whether the purpose of a discriminatory or restrictive measure is suitable, necessary and appropriate measured against the purpose of the fundamental freedoms.

In the case of the obligation to afford MFN treatment, the result is clear. Fiscal sovereignty includes principally the power to negotiate the allocation of taxing rights in tax treaties. This power is guaranteed by the second indent of Art. 293 of the EC Treaty. The contracting states may also agree on an allocation that results in a higher tax burden than that which would arise if the taxpayer were taxed in only one of the contracting states.[117] It is for the Member States to decide which allocation of taxing rights

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[112] In practice, the ECJ often appears not to observe the Member States' fiscal sovereignty sufficiently, for which the ECJ is often heavily and rightly criticized. See note 41, supra.

[113] See note 78, supra.

[114] See Arts. 94 and 95(2) of the EC Treaty.

[115] See Wieland, supra note 41 (pointing out the same requirement under German constitutional law as regards the basic rights referred to as "*praktische Konkordanz*").

[116] See O'Shea, T., "The ECJ, the '*D*' case, double tax conventions and most-favoured-nations: comparability and reciprocity", 14 *EC Tax Review* 190 (2005), at 197, footnote 82; see also Lang, M., "Das EuGHUrteil in der Rechtssache D. – Gerät der Motor der Steuerharmonisierung ins Stottern?", 15 *Steuer & Wirtschaft International* 365 (2005), at 372 et seq. (applying the proportionality principle, but reaching a different result from the ECJ and this author).

[117] See e.g. *Gilly*, supra note 46. See also Wolvers, supra note 9, at 257 (comments of F. Engelen); and Terra and Wattel, supra note 28, at 60 et seq.

best meets their fiscal interest. In this respect, the Member States may regard differing rules relating to non-residents from different Member States as appropriate. To ensure that the fiscal interests of all the contracting states are satisfied, the negotiation of tax treaties is based on reciprocity. A contracting state waives some taxing rights in favour of the other contracting state, but a contracting state is willing to do so only if the other contracting state also waives its taxing rights to an equal extent. It therefore appears that tax treaties are a well-balanced system allocating taxing rights to the contracting states.[118] The denial of MFN treatment is suitable and necessary to enable the Member States to allocate their taxing rights as they see fit.[119] It is also appropriate. Fiscal sovereignty is overwhelmingly important for the Member States because it enables them to raise revenue to fund their budget. In this respect, the Member States must be allowed to agree with the other Member States to what extent each Member State is allowed to tax income/wealth. The ECJ is in line with this view since it rightly distinguishes – albeit not at the justification level – between the allocation of taxing rights and the exercise of taxing rights.[120] Only the latter must comply with the fundamental freedoms; with regard to the former, the contracting states have unfettered discretion. The MFN treatment situation must be attributed to the former, i.e. the Member States' fiscal sovereignty prevails over the fundamental freedoms. The power to decide on the optimal allocation of taxing rights includes the power to decide on differing rules in relation to different states. Such differing rules may be necessary because the circumstances influencing the connecting factors for the allocation of taxing rights may be different.

Many authors have argued that the above-mentioned ECJ case law not allowing the Member States to justify discrimination or restriction on grounds of tax treaty obligations[121] shows that reciprocity in the allocation of taxing rights may not be a suitable justification.[122] They rightly point out that the ECJ has repeatedly ruled that the fun-

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[118] See Avery Jones, supra note 44, at 97; and Kemmeren, supra note 47, at 147 at seq. The fact that tax treaties contain provisions other than those allocating taxing rights (see Wolvers, supra note 9, at 257 (comments of F. Engelen); Farmer, supra note 4, at 138; and van der Linde, supra note 50, at 14) does not prevent the assumption that the allocation of taxing rights is based on reciprocity. For the economic concepts underlying the allocation of taxing rights in tax treaties, see Verdoner, L., "Major Economic Concepts in Tax Treaty Policy", 31 *Intertax* 147 (2003).

[119] The ECJ is incorrect if, in the decision in the "*D*" case, it says that no "allocation of taxing powers" was at issue (see note 2, supra, Para. 53). Providing a different allocation of taxing rights in relation to different states is, of course, an issue of allocation of taxing powers if this results in the different tax treatment of non-resident taxpayers.

[120] See the ECJ cases cited in note 108, supra.

[121] Id.

[122] See Farmer, supra note 4, at 152 et seq.; Herzig and Dautzenberg, supra note 78, at 2523; Kraft and Robra, supra note 15, at 251; Lang, supra note 116, at 371 et seq.; Schuch, "Werden die Doppelbesteuerungsabkommen durch EU-Recht zu Meistbegünstigungsklauseln", supra note 40, at 125 et seq.; Schuch, "'Most-

damental freedoms are unconditional and may not be made subject to reciprocal agreements between the Member States. However, this case law affects only the exercise of taxing rights, not their allocation.[123] Such an objection is therefore not suitable to counter the justification of interference with the fundamental freedoms on grounds of reciprocity.

From this perspective, the result reached in the "*D*" case is right. The reciprocity in tax treaties is an objective justification for discriminating between non-residents from different Member States. The issue now is whether a benefit that is granted to non-residents from another Member State and that is invoked by a nonresident from a third Member State is based on the reciprocal limitation of the Member States' taxing rights. As regards the "*D*" case, it may be argued that the tax benefit granted to residents of Belgium under the Belgium–Netherlands tax treaty is only unilateral since Belgium does not levy a wealth tax[124].Thus, only residents of Belgium with wealth located in the Netherlands may take advantage of the provision in question. By contrast, the ECJ ruled that one must consider a tax treaty as a whole. Thus, the contracting states take into account all their rights and obligations under the tax treaty, irrespective of whether the national tax laws of all the contracting states have an equivalent to the particular aspects regulated in the entire tax treaty. This view is consistent.[125] It is inconceivable that a contracting state will unilaterally grant a benefit to non-residents from the other contracting state without seeking compensation from the latter through a disadvantage. It cannot completely be ruled out, however, that a contracting state nevertheless wants to offer an incentive in a bilateral tax treaty.[126] The basic problem in this case is to actually identify the unilateralism of the benefit. Therefore, it must be assumed that a tax treaty benefit is based on reciprocity unless the opposite can be proved.

A tax treaty benefit available to non-residents of one contracting state is principally compensated by a benefit granted to residents of that state in the other contracting

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favoured-nation clause' in Tax Treaty Law", supra note 57, at 163 et seq.; Tietje, supra note 54, at 410 et seq.; van Thiel, supra note 75, at 455; and Weber and Spierts, supra note 86, at 68 et seq.

[123] See Kemmeren, supra note 47, at 148.

[124] This is the view taken by the Advocate-General in his opinion delivered on 26 October 2004. See also van der Linde, supra note 50, at 15; van Thiel, supra note 75, at 455; and Weggenmann, supra note 74, at 719.

[125] See Wolvers, supra note 9, at 257 (comments of F. Engelen and E. Kemmeren); Lang, supra note 116, at 370; and Meussen, G.T.K., "The Advocate General's Opinion in the '*D*' Case: Most-Favoured-Nation Treatment and the Free Movement of Capital", 45 *European Taxation* 2 (2005), at 52, 55.

[126] For possible examples of unilateral benefits, see Cloer, A., "EWS-Kommentar", 16 *Europäisches Wirtschafts- und Steuerrecht* 423 (2005); Haunold, P., M. Tumpel and C. Widhalm, "EuGH: Das Ende der DBAMeistbegünstigung?", 15 *Steuer & Wirtschaft International* 494 (2005); and Thömmes, supra note 74, at 888. According to Schuch, J., "Critical notes on the European Court of Justice´s D case decision on most-favoured-nation treatment under tax treaties", 15 *EC Tax Review* 6 (2006), at 8, the "D" decision does not leave space for unilateral benefits.

state. Therefore, the benefit does not necessarily fit in the system providing for the allocation of taxing rights in relation to a third Member State (i.e. the residence state of the taxpayer invoking MFN treatment). An obligation to grant MFN treatment would disturb the balance of the tax treaty between the latter Member State and the Member State that would be obliged to grant MFN treatment.[127]

### 3.2.4 Undecided issues

Pursuant to the tradition of judicial self-restraint, the decision in the "*D*" case ruled only on the issues relevant to that case. Accordingly, the ECJ ruled only that a Member State need not treat a non-resident from another Member in the same way as a non-resident from a third Member State. However, there are a few other situations which may raise the question of MFN treatment.

The first issue not decided by the ECJ is what happens in relation to third countries. In principle, there are two separate issues, namely, the issue of a non-resident from a non-EU country claiming to be treated like a non-resident from a Member State, and the issue of a non-resident from a Member State claiming to be treated like a non-resident from a non-EU country. Some authors have argued that MFN treatment must also be extended to third countries in particular circumstances.[128] This is principally true, but two cases must be distinguished. The obligation to afford MFN treatment under EC law may be conceivable only if the scope of the fundamental freedoms covers such an obligation. Therefore, from the outset, it is clear that a non-resident from a non-EU country may not claim MFN treatment.[129] The fundamental freedoms in principle apply only to the nationals of the Member States. The only exception is the free movement of capital, which also applies to situations involving third countries.[130] Thus, only non-residents from the Member States may invoke MFN treatment unless the free movement of capital applies.[131]

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[127] This is the tax treaty whose reciprocity is protected. For a different view, see van der Linde, supra note 50, at 16 (examining a disturbance of the tax treaty with the most favourable benefit invoked by the taxpayer).

[128] See e.g. Wassermeyer, supra note 72, at 32; and Weggenmann, supra note 1, at 683.

[129] It is important to note again that residence is not the decisive aspect for the applicability of the fundamental freedoms. The above comment is based on the assumption that a non-resident from a non-EU country is not a national of a Member State.

[130] Even the fundamental freedoms do not protect a person from restrictive tax provisions (see Art. 58(1)(a) of the EC Treaty). In 2004, the BFH denied MFN treatment on grounds of this limitation on the free movement of capital (judgement of 26 May 2004, I R 54/03, (2004) *Bundessteuerblatt* II 767). On this ground for rejecting the MFN obligation, see Hinnekens, supra note 78, at 297.

[131] See Lang, supra note 116, at 373 (assuming that not even the free movement of capital grants MFN treatment regarding tax treaty benefits to non-residents from non-EU countries, although it generally applies to such non-residents and, in his view, grants MFN treatment regarding tax treaty benefits to non-residents from the EU Member States).

Regarding non-residents from the Member States, one may wonder whether tax treaties with non-EU countries must be considered. It may be argued that only the free movement of capital applies to transactions with taxpayers from third countries. But this view is too restrictive. Only the free movement of capital applies to transactions involving taxpayers from third countries. In this context, the issue is whether tax treaties with non-EU countries may serve as a standard for MFN treatment. The question should be answered in the affirmative. To the extent a tax treaty with a non-EU country provides a more favourable tax treatment for non-residents than the tax treaty with a Member State, non-residents from the Member States may invoke the same benefit. Considering the purpose of the fundamental freedoms (i.e. the optimal allocation of resources within the EC), a non-resident from a Member State may see himself in a less favourable position than a non-resident from a non-EU country, preventing him from engaging in the intended cross-border business activities which he considers to best allocate the resources.[132] Therefore, non-EU tax treaties may principally serve as a standard for MFN treatment. This is true for all situations protected by the fundamental freedoms and the general non-discrimination clause, not only for those falling under the free movement of capital.

Third countries might in principle play a role with respect to the MFN treatment issue under EC law. The above comments, however, did not consider the option of justifying the denial of MFN treatment in cases involving non-EU countries. According to the above view regarding situations not involving third countries, the MFN obligation, which is principally established by the fundamental freedoms and the general non-discrimination clause, may be denied on grounds of the reciprocity argument.

The second open issue in the "*D*" case is whether the residence state may also be obliged to grant MFN treatment regarding tax treaty benefits.[133] The "*D*" case concerned only a possible MFN obligation of the source state regarding the treatment of non-residents from different Member States. As regards the general applicability of the fundamental freedoms to such a scenario, the question must be answered in the affirmative. It is commonly acknowledged that the fundamental freedoms and the general non-discrimination clause also protect the outbound activities of residents from

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[132] See Kraft and Robra, supra note 15, at 252; and Pistone, P., "Towards European international tax law", 14 *EC Tax Review* 4 (2005), at 8 (pointing to Art. 10 of the EC Treaty which contains the principle of Community loyalty). Accordingly, a Member State may not grant a benefit to residents of third states if it does not want to grant the benefit to residents of another Member State.

[133] See Rödder and Schönfeld, supra note 36, at 525 (raising the issue and pointing out activity provisos which restrict the taxation of permanent establishments by the source state). See also Wassermeyer, supra note 57, at 162 et seq.; and Weggenmann, supra note 74, at 720.

discrimination or restriction in their residence state.[134] Considering the intention of the fundamental freedoms (i.e. the optimal allocation of resources within the EC), such activities must also be covered by the MFN obligation. In the end, however, the same reservations apply to the MFN treatment obligation of the residence state as to the MFN obligation of the source state. In each case, a tax treaty is based on reciprocity of the rights and obligations regulated in the treaty. Therefore, the Member States' fiscal sovereignty, which empowers them to enter into tax treaties allocating taxing rights, must prevail over the fundamental freedoms. This cannot be contradicted by reference to the fact that such differences are regularly based on "an abuse of a dominant position",[135] i.e. tax treaties with small countries often contain restrictive provisions, whereas those with major countries are usually more favourable. Even if this observation is correct,[136] tax treaties are based on the negotiations of the contracting states which exercise their fiscal sovereignty. The argument of "an abuse of a dominant position" is not relevant in the context of the fundamental freedoms. As with the difficulties in determining whether a tax treaty benefit is based on reciprocity, one cannot find the criteria for drawing the line between a fair agreement and one based on the abuse of a dominant position. Ultimately, this issue concerns fair tax competition, an area in which the fundamental freedoms may not play a role.

### 3.2.5 Future developments

The issue of MFN treatment under EC law will be subject to much discussion not only because of the undecided issues mentioned above, but also because the ECJ will have to deal with the issue again. Courts in the Netherlands[137] and the United Kingdom[138] have referred other cases to the ECJ. On 15 December 2005, however, the Dutch court withdrew its request for a preliminary ruling because the facts of the Dutch case were similar to those of the "*D*" case. But the case would not have brought a new conclu-

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[134] See note 81, supra.

[135] See Rödder and Schönfeld, supra note 36, at 526 (making this argument).

[136] Id. at 526 (pointing out that Germany's tax treaties with France and the United Kingdom do not have an activity proviso, whereas its tax treaty with Finland does).

[137] Case C-8/04, *Bujara v. Inspecteur van de Belastingsdienst Limburg/Kantoor Buitenland te Heerlen*, *OJ* C 59, 6 March 2004, at 17. The facts of this case are very similar to those of the "*D*" case, except that *Bujara* concerns the income tax.

[138] Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, *OJ* C 273, 6 November 2004, at 17-18. Like *Hoechst and Metallgesellschaft* (supra note 61), the case concerns the benefits regarding the UK advance corporation tax (ACT). The availability of the benefits depends on the residence of the parent company or on relevant tax treaty provisions. Only certain tax treaties have the latter. On this case, see Martin, P., "*D v. Rijksbelastingsdienst*: Case C-376/03: A Review", 6 *Tax Planning International European Focus* 17 (No. 11, 2004), at 18.

sion on the issue of MFN treatment.[139] By contrast, the UK case may address some issues regarding rules that do not relate specifically to double taxation relief so that the ECJ might not use the reciprocity argument.[140] In this case, MFN treatment will be intensively discussed in the literature on the subject.

# 4 Conclusion

This article has shown that the obligation to grant MFN treatment regarding tax treaty benefits is rare. Neither general international tax law nor international trade law (in particular multilateral trade agreements) obliges states to grant MFN treatment; nor does EC law contain such an obligation. Only if a state concludes a (in most cases, bilateral) tax treaty or trade agreement which contains an MFN clause covering direct taxes, including tax treaty benefits, may taxpayers enjoy MFN treatment.[141] This result must be accepted as long as states have fiscal sovereignty. If one wants to avoid the distortions caused by differing tax treaty provisions, one must go the way of "positive integration" (i.e. harmonization of tax treaties).[142] However, even within the EC, which might be a suitable forum for such integration, experience has shown that the Member States will try to safeguard their fiscal interests and refrain from a step forward if their fiscal interests are endangered.

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[139] See Kofler and Schindler, supra note 94; and Thömmes, O. and K. Nakhai, "ECJ rejects most-favoured-nation argument in the *D* Case", 33 *Intertax* 479 (2005).

[140] Id. The Advocate-General, however, denied an obligation to MFN treatment by reference to the "*D*" case in his opinion delivered on 23. February 2006.

[141] This is particularly true for the EC. See de Graaf and Janssen, supra note 14, at 187; and Kemmeren, supra note 47, at 148. See also Weber, supra note 63, at 443 et seq. (proposing the inclusion of a (general) MFN clause in EC law).

[142] See Hinnekens, L., "Compatibility of Bilateral Tax Treaties with European Community Law – Application of the Rules", 4 *EC Tax Review* 202 (1995), at 213.

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