Bloomberg BNA

Tax Management
International Journal™

Reconsidering European Court of Justice Jurisprudence on Limitation on Benefits Clauses: Why the U.S. Should Care

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INTRODUCTION

On November 19, 2015, the European Commission (''Commission'') issued an infringement action against the Netherlands on the grounds that the ''limitation on benefits'' (''LOB'') clause in its bilateral tax treaty with Japan violates European Union (''EU'') law.[2] The action requested that the Dutch government amend the treaty's LOB clause within two months or face referral to the European Court of Justice (''ECJ'').[3] This two-month period lapsed in January 2016 and, to date, the Netherlands has yet to respond — placing an interesting, and hopefully clarifying, test case on the docket.[4]

In *Class IV ACT*,[5] the ECJ explicitly upheld the LOB provisions in a double taxation convention as compatible with EU law.[6] Following this decision, the compatibility of LOB provisions appeared a closed case to some. Nevertheless, many academics and professionals find the analysis conducted in the case lackluster and doubt its finality.[7] The recent infringement action illustrates the very open nature of this issue.

Should the case be referred, the ECJ will likely conduct a full analysis of the compatibility of the LOB provisions in the Netherlands-Japan bilateral tax treaty to provide more useful and robust guidance for Member States, rather than simply discarding the is-

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This article is based on Ms. Leon's co-winning paper in the 2016 Student Writing Competition sponsored by the USA Branch of the International Fiscal Association. Ms. Leon will receive her prize at the 2017 annual meeting of IFA-USA. She prepared the paper in conjunction with an EU Taxation seminar taught by Professor Ruth Mason and would like to thank Professor Mason for all of her guidance and support along the way.

[2] European Commission Press Release MEMO/15/6006, November Infringements Package: Key Decisions (Nov. 19, 2015), http://europa.eu/rapid/press-release_MEMO-15-6006_en.htm.

[3] *Id.*

[4] Alan Connell et al., *European Union: The Recent Intrusion of the European Commission into Double Tax Treaties*, Mondaq (Mar. 16, 2016), http://www.mondaq.com/x/474622/tax+treaties/The+Recent+Intrusion+Of+The+European+Commission+Into+Double+Tax+Treaties; Tom O'Shea, *Limitation on Benefits Clauses and EU Law: Examining the Japan-Netherlands LOB*, 82 Tax Notes Int'l 289 (2016); European Comm'n, *Infringement Proceedings: Status*, http://ec.europa.eu/atwork/applying-eu-law/infringements-proceedings/infringement_decisions/index.cfm?lang_code=EN&r_dossier=20144233&noncom=0&decision_date_from=19%2F11%2F2015&decision_date_to=19%2F11%2F2015&active_only=0&title=&submit=Search (revealing the infringement action remains an active case, see infringement number 20144233).

[5] Case C-374/04, *Test Claimants in Class IV of the ACT Group Litig. v. Comm'r of Inland Revenue*, 2006 E.C.R. I-11673.

[6] *Id.* at ¶89.

[7] *See, e.g.,* Servaas van Thiel, *The Direct Income Tax Case Law of the European Court of Justice: Past Trends and Future Developments*, 62 Tax L. Rev. 143, 175 (2008) (''[t]he court is likely to fine-tune the ACT Test Claimants decision''); José Calejo Guerra, *Limitation on Benefits Clauses and EU Law*, 51 European Tax'n 85, 87 (2011) (''both the ECJ and the Advocate General rapidly dismissed the issue'').

ISSN 0090-4600

sue under a comparability analysis, as in *Class IV ACT*. The LOB provisions will likely be viewed as restrictive of the fundamental freedoms of the Treaty on the Functioning of the European Union, but potentially justified.

IMPORTANCE OF THIS 'EU' ISSUE TO THE UNITED STATES

If the ECJ should find the LOB provisions at hand incompatible with EU law, the implications would be immense. The United States, India, and Japan place tremendous value on these provisions[8] because they effectively combat abusive treaty shopping.[9] In fact, the preamble to the new 2016 U.S. Model Income Tax Convention proclaims that the inclusion of objective LOB rules in tax treaties to prevent treaty shopping and abuse has been ''a fundamental pillar of U.S. tax treaty policy for over two decades.''[10] Although the revised 2016 model LOB article includes a derivative benefits test[11] and a headquarters company test in recognition of the reality that multinationals conduct business through many subsidiaries around the world, ''a number of the preexisting LOB tests have been tightened.''[12] This tightening indicates the resilient importance of the LOB article to U.S. policymakers and to preventing treaty abuse.

If the ECJ finds the LOB provisions in the Netherlands-Japan bilateral tax treaty to be incompatible with EU law, Member States would be forced to renegotiate countless treaties, all while becoming less attractive negotiation partners. Furthermore, the language in the Netherlands-Japan bilateral tax treaty under scrutiny mirrors the language used by the United States in many of its current bilateral tax treaties in force.[13] Thus, such a finding by the ECJ would also greatly affect the United States by rendering its favored and revered treaty abuse prevention tool unavailable in renegotiations with EU nations and creating uncertainty as to the status and enforceability of its current treaties with such nations in the interim. An adverse decision would also place the Base Erosion and Profit Shifting (''BEPS'') project in jeopardy, or at least make negotiations more difficult and lively, as the current proposal includes LOB provisions modeled primarily off treaties concluded by the United States, Japan, and India.[14]

Given these potential implications, European and American tax professionals alike should take interest in the progress of the Commission's infringement action against the Netherlands.

OVERVIEW OF RELEVANT CASE LAW

In its press release regarding the infringement action, the Commission specifically cited *Open Skies*[15] and *Gottardo*.[16] Additionally, the ECJ will also likely consider *D v. Inspecteur*[17] and *Class IV ACT*.[18]

'Open Skies'

The *Open Skies* cases involved bilateral airline transportation treaties concluded between various Member States and the United States. The treaties included ''nationality clauses,'' which function similarly to the ownership tests in LOBs. Take, for example, the nationality clause in the U.K.-U.S. Open Skies treaty:

- If a U.K. airline was controlled by nationals of the United Kingdom or any other contracting

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[8] Filip Debelva et al., *LOB Clauses and EU-Law Compatibility: A Debate Revived by BEPS?* 24 EC Tax Rev. 132, 132 (2011).

[9] *See U.S. Technical Explanation of the Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income: Article 26, Limitation on Benefits* (1992), https://www.irs.gov/Businesses/International-Businesses/Netherlands-Technical-Explanation (describing the rationale).

[10] U.S. Dep't of Treasury, *Preamble to 2016 U.S. Model Income Tax Convention* 4 (Feb. 17, 2016), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US%20Model-2016.pdf.

[11] Though ''most existing U.S. tax treaties with countries in the European Union'' include some form of the derivative benefits test, the model LOB article previously did not include such a test and currently modifies the test included in most U.S. tax treaties with EU nations. *Id.* at 5.

[12] *Id.* at 4.

[13] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income art. 26, Neth.-U.S., Dec. 18, 1992, 2 U.S.T. 1483; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, art. 21, Neth.-Japan, 25 Aug. 2010, https://www.government.nl/documents/directives/2010/08/25/tax-treaty-between-japan-and-netherlands [hereinafter Netherlands-Japan Tax Treaty].

[14] OECD, OECD/G20 BEPS Project, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, Action 6: 2015 Final Report (Oct. 5, 2015), http://www.oecd-ilibrary.org/docserver/download/2315331e.pdf?expires=1460579559&id=id&accname=guest&checksum=3CEB0E42787AB4B025F0F11657376F85.

[15] Case C-466/98, *Comm'n v. United Kingdom*, 2002 E.C.R. I-09427; *see also* Case C-467/98, *Comm'n v. Denmark*, 2002 E.C.R. I-09519; Case C-468/98, *Comm'n v. Sweden*, 2002 E.C.R. I-09575; Case C-469/98, *Comm'n v. Finland*, 2002 E.C.R. I-09627; Case C-471/98, *Comm'n v. Belgium*, 2002 E.C.R. I-09681; Case C-472/98, *Comm'n v. Luxembourg*, 2002 E.C.R. I-09741; Case C-475/98, *Comm'n v. Austria*, 2002 E.C.R. I-09797; Case C-476/98, *Comm'n v. Germany*, 2002 E.C.R. I-09855 [cases collectively hereinafter *Open Skies*].

[16] Case C-55/00, *Gottardo v. INPS*, 2002 E.C.R. I-00413.

[17] Case C-376/03, *D v. Inspecteur*, 2005 E.C.R. I-05821.

[18] Case C-374/04, *Test Claimants in Class IV of the ACT Group Litig. v. Comm'r of Inland Revenue*, 2006 E.C.R. I-11673.

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Member State with an Open Skies treaty with the United States, then the United States provided benefits.

- However, if an airline was ultimately controlled by nationals of a non-contracting Member State, then the United States could choose to provide no benefits.[19]

The ECJ ruled that the clauses violated the freedom of establishment[20] because they discriminated on the basis of nationality by making it less advantageous for nationals of other Member States to establish airlines in the United Kingdom than it was for British nationals.[21] In the proceedings, the United Kingdom argued that it did not treat the airlines controlled by nationals of other Member States differently itself, but rather the U.S.'s conduct gave rise to the discrimination when it chose whether or not to extend the benefits. The ECJ disagreed, instead viewing the United Kingdom's acknowledgment of the U.S.'s right to deny the benefits in the treaty terms as discrimination in and of itself.[22]

Although *Open Skies* did not deal with tax treaties, the cases arguably provide the best precedent for the LOB context as the nationality clauses and LOB provisions are functionally analogous.[23] Applying the reasoning of *Open Skies*, LOB provisions are discriminatory: including an LOB provision in a bilateral tax treaty acknowledges the right of another country to deny benefits to some tax residents merely on the basis of nationality of their beneficial owners. The ECJ did not even mention *Open Skies* in *Class IV ACT*, instead citing *D v. Inspecteur*. Many argue that *Open Skies* should have been (and should still be) the applicable precedent to apply to the LOB context.

'Gottardo'

In *Gottardo*, another non-tax, yet analogous case, an Italy-Switzerland treaty provided that Italian nationals could include years worked in Switzerland toward calculating the minimum years required to receive an Italian pension; other Member State nationals could include only years worked in Italy.[24] The ECJ found the treaty provision incompatible with EU law and asserted that ''the fundamental principle of equal treatment requires that, that Member State grant nationals of other Member States the same advantages as those which its own nationals enjoy under that convention unless it can provide objective justification for refusing to do so.''[25]

Again applying this logic, the LOB provisions appear quite problematic: like the claimant in *Gottardo*, non-Dutch nationals owning companies in the Netherlands are denied the very benefits that Dutch nationals owning companies in the Netherlands enjoy as a function of the treaty.

The 'D' Case

In *D*, the ECJ considered a challenge brought by Mr. D, a German resident individual, of the Netherlands' refusal to grant him a personal allowance for his wealth tax.[26] The Belgium-Netherlands Convention for the Avoidance of Double Taxation extended a personal allowance to all Belgian residents regardless of the normal rule that only nonresidents holding 90% of their wealth in the Netherlands received the allowance. Mr. D argued, in part, that his different treatment compared to a similarly situated Belgian resident constituted discrimination.[27] The ECJ rejected this argument, commenting that ''[t]he fact that those reciprocal rights and obligations apply only to persons resident in one of the two Contracting Member States is an inherent consequence of bilateral double taxation conventions.''[28] Because the taxpayers were not comparable, the different treatment did not constitute discrimination. Although the case did not involve LOB provisions, the ECJ relied on the above reasoning to uphold the LOB provisions in *Class IV ACT*.

'Class IV ACT'

In *Class IV ACT*, the ECJ considered whether LOB provisions in a double tax treaty violated EU law for the first time. The LOB provisions in the treaty between the Netherlands and the United Kingdom look eerily similar to the nationality clauses struck down in *Open Skies*:

- When a U.K. company paid a dividend to a Netherlands resident company beneficially owned by Netherlands residents, the United Kingdom granted an imputation credit.
- However, when a Netherlands resident company was beneficially owned by nonresidents of the Netherlands, the United Kingdom granted no such

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[19] *United Kingdom*, C-466/98 at ¶10.

[20] Consolidated Version of the Treaty on the Functioning of the European Union, art. 50, Mar. 30, 2010, 2010 O.J. (C 83) 47, 68 [hereinafter ''TFEU''].

[21] *United Kingdom*, C-466/98 at ¶¶47–48, 51.

[22] *Id.* at ¶51.

[23] For further discussion of the functional similarities, see Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice*, 59 Tax L. Rev. 65, 82–85 (2005).

[24] Case C-55/00, *Gottardo v. INPS*, 2002 E.C.R. I-00413, ¶19.

[25] *Id.* at ¶34.

[26] Case C-376/03, *D v. Inspecteur*, 2005 E.C.R. I-05821, ¶¶4–9.

[27] *Id.* at ¶2.

[28] *Id.* at ¶61.

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credit, unless the beneficial owner's state of residency also had an agreement with the United Kingdom providing for the imputation credit.[29]

Relying on *D*, the ECJ upheld the LOB clauses as compatible with EU law. No discrimination occurred because the two situations were not comparable, the former being subject to a treaty and the latter not.[30]

Although the ECJ did not explicitly approve all LOB provisions, it approved the mechanism's functional result. The analysis runs counter to the analogous precedent in *Open Skies* and *Gottardo*, neither of which were mentioned in the ECJ's judgment or in the Advocate General's opinion.[31] Faced with subsequent dissatisfaction and the Commission's explicit citing of *Open Skies* and *Gottardo*, the ECJ will likely conduct a more traditional discrimination analysis rather than discarding of the issue at the comparability stage.

WHY THE LOB QUESTION REMAINS OPEN

Aside from the argument that the ECJ failed to analyze the LOB issue under the proper precedents, there are several other reasons *Class IV ACT* will not be dispositive with respect to the Netherlands-Japan LOB provisions.

On the one hand, the ECJ may simply have gotten the comparability question wrong in *Class IV ACT* and will reconsider comparability in a future case. Simply extending the comparability logic of the most-favored nation issue from *D* to the LOB context in *Class IV ACT* may have been improper. *D* involved comparing individual residents of different member states: a resident of the contracting states — e.g., a Belgian resident — and a nonresident of the treaty states — e.g., Mr. D, neither a Belgian nor Dutch resident, but rather a German resident. This comparison looks much more like the traditional rule that residents and nonresidents are not comparable.[32] In *Class IV ACT*, however, both corporations were in fact tax residents of the Netherlands, a contracting state. As a general rule, residents are comparable. Yet, the ECJ analyzed comparability not at the level of the taxpayers but rather at the level of their parents. Based on ECJ jurisprudence, conducting the analysis at the parent level appears questionable. For example, in *Metallgesellschaft*, the ECJ explicitly "held that denial of tax advantages to subsidiaries because their parents were located in other Member States was contrary to EU law."[33] Because of the disconnect between *Class IV ACT* and other ECJ precedent, the ECJ will likely reconsider the comparability question.

On the other hand, some observers such as Dr. Tom O'Shea argue that the ECJ got the comparability question right given the unique U.K. national law involved.[34] The unique provision provided that a nonresident company recipient of dividends is subject to U.K. withholding only if it receives an ACT credit.[35] Thus, the following two taxpayer types are not comparable:

- Nonresident company entitled to a credit via a treaty; and
- Nonresident company not entitled to a credit via a treaty.

Because the nonresident companies are not comparable, the different treatment with respect to withholding taxes — lower rate for the former and no tax for the latter — does not constitute discrimination. This argument seems in line with ECJ dividend jurisprudence: a member state is required to relieve double-taxation on outbound dividends only if it is the state that is responsible for imposing the two layers of tax.[36] However, this argument may improperly conflate the dividend issue and jurisprudence with the more general LOB issue and raw consideration of comparability. It is also questionable whether this case even required considering the LOB issue given the national law involved.

Regardless of the comparability debate, *Class IV ACT* still should not be dispositive on the LOB issue. The case at hand is distinguishable from the unique *Class IV ACT* case. The LOB provisions in the Netherlands-Japan treaty closely tracks the U.S. model treaty.[37] Neither the Netherlands nor Japan seem to condition withholding tax of nonresidents on

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[29] For a good illustration, see Maikel Evers and Arnaud de Graaf, *Pushing Back Frontiers (Un)charted Territories in the Field of International Tax Law and EU Law*, EUCOTAX Series on European Taxation: Sovereignty of the Member States in an Internal Market 151, 176 (Sjaak J.J.M. Jansen ed., 2011).

[30] Case C-374/04, *Test Claimants in Class IV of the ACT Group Litig. v. Comm'r of Inland Revenue*, 2006 E.C.R. I-11673, ¶ 91 (citing *D*, C-376/03 at ¶61).

[31] *Id.* at I-11676–717 (opinion of Mr. Geelhoed, Feb. 23, 2006); Guerra, above n. 7.

[32] Case C-279/93, *Finanzamt v. Schumacker*, 1995 E.C.R. I-00225, ¶31.

[33] Ruth Mason, *Primer on Direct Taxation in the European Union* 114 (2005) (citing Cases C-397/98 and C-410/98, *Metallgesellschaft & Hoechst v. Comm'r of Inland Revenue*, 2001 E.C.R. I-01727).

[34] *Class IV ACT*, C-374/04 (opinion of AG Geelhoed) at 11680, ¶13, n. 17; Tom O'Shea, *Netherlands-U.S. Air Transport Agreement Won't Fly, ECJ Says*, 46 Tax Notes Int'l 790, 792 (2007).

[35] *Class IV ACT*, C-374/04 (opinion of AG Geelhoed) at 11680, ¶13, n. 17.

[36] Walter Hellerstein et al., *Constitutional Restraints on Corporate Tax Integration*, 62 Tax L. Rev. 1, 34–35 (2008).

[37] U.S. Dep't of Treasury, U.S. Model Income Tax Convention (2016), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf; U.S. Dep't of

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receipt of a credit like the unique U.K. national legislation;[38] and the United States certainly does not.[39] Because most national legislation does not contain an ameliorative provision like that of the United Kingdom, the ECJ should reconsider the LOB question.[40] Furthermore, ECJ jurisprudence suggests that a member state may not rely on a treaty partner's counterbalancing of a disadvantage to justify its discrimination.[41] Thus, the Netherlands should not have even been allowed to enter into a treaty that allowed another country to discriminate on the basis of beneficial owner nationality simply because the U.K. national legislation at the time counteracted the discrimination.

TRADITIONAL DISCRIMINATION ANALYSIS OF THE NETHERLANDS-JAPAN LOB PROVISION

Given that the Netherlands-Japan case appears distinguishable, the ECJ will likely conduct its traditional three-prong analysis when considering the compatibility of the LOB provisions with the EU fundamental freedoms.

Does the LOB Provision Constitute a Restriction?

When considering whether a law constitutes discrimination or a restriction, the ECJ first considers whether the taxpayers under consideration are comparable. Even after setting aside *Class IV ACT* as unique, one must ask how far the ECJ will push its reasoning in *D* that taxpayers subject to a tax treaty are incomparable with those not subject to the treaty because of the inherent reciprocity of bilateral tax treaties.[42] With all due respect to the ECJ, the comparability reasoning in *D* simply cannot stand in the LOB context — and many others — as it does not align with the ECJ's discrimination jurisprudence or the EU treaty.

If the reasoning stands, member states would effectively be allowed to use bilateral treaties as tools to discriminate against those it chooses to define as not covered by its treaty, even if this definition hinges on nationality or a nationality proxy. To analogize, this result would be tantamount to that of analyzing state aid cases under the ''normal regime approach'' rejected in *Gibraltar* as it would ''disregard[] the possibility that a Member State may introduce a tax system which is inherently discriminatory by its very structure.''[43] For example, LOB provisions would allow Member States to treat once comparable residents differently simply by recasting them as incomparable based on negotiated treaty terms. The ECJ did not consider this concerning result in *D*, perhaps because such sweeping reasoning was not necessary to the ECJ's ultimate holding since the two taxpayers were incomparable *before* applying the treaty terms: a resident in a contracting state and a resident in a noncontracting state. *D* sets the stage for Member States to embed discrimination in the very structure of their tax systems. As Professor Servaas van Thiel puts it, this reasoning has created ''a sort of 'above the law' status for tax treaties.''[44] This result is untenable — unless the ECJ wishes to threaten the effectiveness of the once-powerful anti-discrimination principles of EU law. Member States should not be able to contract around the fundamental freedoms.

The ECJ should instead consider comparability under the lens of *Open Skies*, a more analogous case. For example, consider the following taxpayers:

- A Netherlands resident company with qualifying beneficial owners receiving treaty benefits from Japan; and
- A Netherlands resident company without qualifying beneficial owners not receiving treaty benefits from Japan.

The taxpayers are comparable because they are both *resident companies* under Netherlands national law

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Treasury, U.S. Model Income Tax Convention (2006), https://www.irs.gov/pub/irs-trty/model006.pdf.

[38] *See, e.g.,* Gov't of Netherlands, *Taxation and Business: Dividend Tax*, https://www.government.nl/topics/taxation-and-businesses/contents/dividend-tax; *Dutch Withholding Taxes on Outbound Payments*, Tax Consultants Int'l, http://tax-consultants-international.com/read/Dutch_withholding_taxes; Kumiko Watanabe and Brandon Boyle, *International Tax Flash: Changes in Japan's Domestic Withholding Tax Rate on Dividends May Affect U.S. Residents*, Grant Thornton (Feb. 10, 2014), http://www.grantthornton.com/issues/library/alerts/tax/2014/Flash/Changes-in-Japan-tax-rate.aspx#sthash.nUEuxeqL.dpuf.

[39] Internal Revenue Code §871(a)(1), §881(a)(1).

[40] Evers and de Graaf, above n. 29, at 177 (speculating the ECJ will likely be asked to clarify).

[41] Case C-379/05, *Amurta SGPS v. Inspecteur*, 2007 E.C.R. I-09569, ¶78 (a Member State ''cannot rely on the existence of a tax advantage granted unilaterally by another Member State in order to escape its obligations under the [fundamental freedoms]'').

[42] Case C-376/03, *D v. Inspecteur*, 2005 E.C.R. I-5852, I-05821, ¶61.

[43] Case C-106/09, *Gibraltar v. European Comm'n*, E.C.R. 2011 I-11113, ¶49.

[44] van Thiel, above n. 7 at 153; *see also* Eric Osterweil, *Are LOB Provisions in Double Tax Conventions Contrary to EC Treaty Freedoms?* 5 EC Tax Rev. 236, 245 (2009) (noting the ECJ interpretation seems to result in ''discrimination between two EU residents [being] allowed as long as DTC language authorizes an EU Member State to treat foreign persons more favorably than those not covered by a tax treaty'').

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before the application of the treaty, much like the airlines in *Open Skies*. They should not be made incomparable and subjected to different treatment merely because the treaty terms alter the definition of residency.

By agreeing to the LOB provisions in the treaty, the Netherlands created a situation in which it is less advantageous for the nationals of other Member States to establish a subsidiary in the Netherlands than for its own nationals. Under *Open Skies*[45] and the ECJ's extensive discrimination jurisprudence,[46] such a disadvantage constitutes a restriction of the freedom of establishment. Nevertheless, the restriction may be justified.

Is the Restriction Justified?

Next, the ECJ will consider whether the restriction can be justified. A restriction is permissible ''only if it pursues a legitimate objective compatible with the Treaty and is justified by overriding reasons in the public interest.''[47]

LOB provisions are an effective and accepted method of preventing treaty shopping, a form of tax abuse and avoidance. The ECJ has accepted prevention of tax avoidance as a justification, both in concert with other justifications[48] and on its own.[49] In fact, according to the ECJ, the freedom of establishment ''presupposes the *actual* establishment of the company in the host Member State and the pursuit of genuine economic activity there.''[50] The LOB provisions of a tax treaty are an attempt to smoke out these conduits that are not entitled to the protections of the freedom of establishment and tax treaty benefits.

The ECJ has also accepted the objective of ensuring a balanced allocation of taxing powers as a justification. The justification reflects that a member state should be able to take measures to ensure its ability to tax the economic activity that takes place in its jurisdiction.[51] Traditionally, challenged mechanisms ensure the balance between contracting states, but because the justification has been framed in very broad terms, an untraditional argument may gain traction. Here, the mechanism instead is an attempt to ensure the proper balance between contracting states and non-contracting states (i.e., the states of treaty-shoppers). The logic behind the justification applies similarly and should be accepted. Just as a member state may ensure its ability to tax economic activity within its borders, the member state should also be able to ensure it extends negotiated treaty benefits only with regard to genuine economic activity within its borders.

Is the Restriction Proportional?

Finally, the LOB provisions will also have to meet the principle of proportionality. The principle requires that a justified, restrictive mechanism be ''appropriate to ensuring the attainment of the objective thus pursued and [] not go beyond what is necessary.''[52] Little doubt exists about the ability of LOB provisions to attain the justified objectives, but most scholars believe the provisions go too far.[53] If the ECJ agrees, it will find LOB clauses incompatible with EU law.

The jurisprudence on prevention of tax avoidance justification raises a high bar in terms of proportionality. Preventative measures must reach only wholly artificial arrangements.[54] Arguably, LOB provisions intend to reach only wholly artificial arrangements, but because of their objective, administrable nature, the provisions often reach non-conduit entities.[55]

Despite this seemingly demanding burden, the ECJ may be walking back from its strict wholly artificial arrangements doctrine; at the very least, the doctrine appears to be in flux. For example, take *Columbus Container*.[56] The ECJ considered switchover rules, which functionally serve the same tax avoidance prevention purposes as the CFC rules in *Cadbury*, a case that insisted upon the wholly artificial arrangements requirement. Yet in *Columbus Container* the ECJ

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[45] Case C-466/98, *Comm'n v. United Kingdom*, 2002 E.C.R. I-09427, ¶¶45–47; *see also* Mason, above n. 23.

[46] *See, e.g.,* Case C-414/06, *Lidl Belgium v. Finanzamt*, 2008 E.C.R. I-03601, ¶¶25–26; Case C-231/05, *Oy AA*, 2007 E.C.R. I-06373, ¶39 (''A difference in treatment between resident subsidiary companies according to the seat of their parent company constitutes an obstacle to the freedom of establishment if it makes it less attractive for companies established in other member states to exercise that freedom. . . .'') (citing Case C-324/00, *Lankhorst-Hohorst*, 2002 E.C.R. I-11779, ¶32, and Case C-524/04 *Test Claimants in the Thin Cap Group Litigation*, 2007 E.C.R. I-02107, ¶61).

[47] Case C-311/08, *SGI v. Belgian State*, 2010 E.C.R. I-00487, ¶56.

[48] Case C-446/03, *Marks & Spencer*, 2005 E.C.R. I-10837, ¶¶44–51.

[49] Case C-196/04, *Cadbury Schweppes v. Comm'r of Inland Revenue*, 2006 E.C.R. I-07995, ¶¶56–57.

[50] *Id.* at ¶¶54–56.

[51] *See, e.g., Oy AA*, C-231/05 at ¶54 (justification allowed ''where the system in question is designed to prevent conduct capable of jeopardising the right of the Member States to exercise their taxing powers in relation to activities carried on in their territory'').

[52] *SGI*, C-311/08 at ¶56.

[53] *See, e.g.,* Dick A. Hofland and Frank P.G. Pötgens, *The LOB Provision in the New Japan-Netherlands Tax Treaty*, 51 European Tax'n 215, 218 (2011); van Thiel, above n. 7, at 181–82.

[54] *Cadbury*, C-196/04 at ¶¶54–56.

[55] Case C-298/05, *Columbus Container v. Finanzamt*, 2007 E.C.R. I-10451.

[56] *Id.*

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failed to even mention the wholly artificial arrangements doctrine and simply disposed of the rules as non-restrictive. Further erosion of the doctrine arguably occurred in *SGI* when the ECJ indicated the wholly artificial arrangements requirement might be relaxed if justifications of both tax avoidance and balanced allocation are present.[57]

Moreover, the ECJ ultimately punts the wholly artificial arrangements question to national courts, leaving room for national court policy, preferences, and politics.[58] Even setting aside the concern of national influences, the application of the doctrine remains opaque and will likely result in inconsistency and uncertainty for taxpayers and treaty partners. For one, the doctrine fails to indicate how narrowly tailored a measure must be to an objective. The analysis focuses on whether a less restrictive measure exists and thus, for all intents and purposes, forecloses a Member State from preventing tax avoidance as there is always some less restrictive measure — e.g., investigating every corporation to determine whether it is a conduit.[59] Given these difficulties and potentially undesirable results, some are even pushing for an alternative. Advocate General Juliane Kokott uses her opinions to urge the ECJ to move away from the wholly artificial arrangements doctrine.[60] Despite having some success, her efforts have also earned her a fair share of criticism.[61]

So, the burning question still remains: Will the Netherlands-Japan LOB provisions pass the proportionality requirement? The answer is ultimately extremely uncertain; however, it is not as dire as some scholars seem to suggest. The ECJ could find the LOB provisions proportional under several theories. First, the ECJ could abandon the wholly artificial arrangements doctrine, simply ignore it, or soften its requirements should the court accept both the prevention of tax avoidance and untraditional balanced allocation justifications based on *SGI*.[62] Second, the ECJ could find the LOB clauses' provision of an opportunity to appeal to the competent authorities to be adequate assurance that only wholly artificial doctrines will be reached.[63] Although increased administrative burden can also constitute a restriction,[64] the ECJ may find the increased burden acceptable given the stakes.[65] Some authors have suggested in the BEPS context that the inclusion of a discretionary relief clause or consultation clause would allow LOB provisions to meet the proportionality requirement.[66] Nevertheless, this proposal would still require amending countless treaties.

Finally, the Netherlands and supporting Member States could make a strong normative argument that treaty shopping and the ability to effectively enter into double taxation conventions are a unique justification that (1) requires powerful tools such as LOB provisions to truly ferret out conduits and (2) should not be subject to the wholly artificial arrangements doctrine at the proportionality stage. Without such provisions, Member States risk losing the ability to effectively negotiate with world economic leaders such as the United States, India, and Japan.[67] Non-EU countries might be loath to enter into agreements without an effective, proven defense mechanism against treaty shopping and to risk that ''a treaty with one state could become a treaty with the world,'' or in this case the entire European Union.[68]

CONCLUSION

Because *Class IV ACT* does not convincingly dispose of the LOB question, the ECJ will likely reconsider the compatibility of LOB provisions with EU law should the Commission refer its complaints regarding the LOB provisions contained in the Netherlands-Japan convention on double taxation. A fuller analysis will provide better guidance for Member States than simply discarding of the issue based on the question of comparability. The ECJ will likely find the LOB provisions restrictive of the freedom of establishment, but potentially justified depending on the ECJ's ongoing development of its wholly artificial arrangements doctrine and its willingness to hear normative arguments from member states.

An ECJ decision on this subject carries potentially far-reaching implications for the United States, as dis-

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[57] *SGI*, C-311/08 at ¶66.

[58] *See, e.g., Cadbury*, C-196/04 at ¶72; *see also, cf.*, Case C-172/13, *European Comm'n v. United Kingdom* (''Marks & Spencer II''), 2015 EUR-Lex CELEX 50, ¶14, 38 (Feb. 3, 2015), http://curia.europa.eu/juris/celex.jsf?celex=62013CJ0172&lang1=en&type=TXT&ancre (ECJ upholds the United Kingdom's very limited amendment of its CFC rules, previously held disproportionate).

[59] *See* Hofland and Pötgens, above n. 53 at 218 and n. 33 (discussing conceivable, less restrictive alternatives).

[60] See discussion regarding *SGI*, a case for which she authored the AG Opinion, above n. 57 and accompanying text.

[61] Servaas van Thiel and Marius Vascega, *X Holding: Ulysses Should Stop Listening to the Siren*, 50 European Tax'n 334 (2010).

[62] *SGI*, C-311/08 at ¶66.

[63] Netherlands-Japan Tax Treaty, above n. 13, at art. 21(7).

[64] *See, e.g.,* Case C-290/04, *Scorpio v. Finanzamt*, 2006 E.C.R. I-09461, ¶46.

[65] *See, e.g.,* Case C-446/04, *Test Claimants in FII Group Litig. v. Comm'r of Inland Revenue*, 2006 E.C.R. I-11753, ¶¶53–56.

[66] Debelva et al., above n. 8, at 142.

[67] See discussion above, under 'Importance of This 'EU' Issue to the United States.'

[68] Richard L. Doernberg, *International Taxation in a Nutshell* 157 (10th ed. 2016).

ISSN 0090-4600

cussed above, and threatens ''a fundamental pillar of U.S. tax treaty policy.''[69] As such, U.S. tax lawyers, planners, and policymakers would be well advised to monitor the progress of the Commission's infringement action and perhaps even take a stab at briefing the legal issues and potential normative arguments.

[69] U.S. Dep't of Treasury, *Preamble to 2016 U.S. Model Income Tax Convention* 4 (Feb. 17, 2016), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US%20Model-2016.pdf.

ISSN 0090-4600