European Union

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# The ECJ's Judgement in *OESF* – Is Horizontal Discrimination a Threat to the Internal Market?

**In its May 2008 judgement in *Orange European Smallcap Fund (OESF)*, the European Court of Justice held that the Dutch restrictions on the relief for the foreign dividend withholding taxes granted to Dutch investment funds are in partial violation of the free movement of capital guaranteed by the EC Treaty. This article describes the ECJ's judgement in *OESF* and its impact on Dutch legislation. The article also considers the consequences of the judgement for the discussion of horizontal discrimination.**

## 1. Introduction

On 20 May 2008, the European Court of Justice (ECJ) issued its judgement in the *Orange European Smallcap Fund* (*OESF*) case.[1] The ECJ concluded that the Dutch restrictions on granting relief for the foreign dividend withholding taxes levied on Dutch investment funds were in partial violation of the free movement of capital guaranteed by the EC Treaty.

This article first describes the ECJ's judgement and its impact on Dutch legislation and then considers the consequences of the judgement. It is clear that EC law prohibits vertical discrimination or, in other words, discrimination by a Member State between e.g. residents and non-residents who are in a comparable situation. More and more cases, however, have raised the question whether EC law also prohibits horizontal discrimination, i.e. whether a Member State must treat a non-resident from another Member State equally to a non-resident from a third Member State.

Based on the *OESF* judgement, the article describes the consequences of *OESF* and previous cases for the discussion of horizontal discrimination. Because horizontal discrimination is mainly the result of the application of bilateral double taxation treaties, they are discussed as well.

With reference to the ECJ's existing case law, specifically on the importance of the OECD Model Tax Convention because of the absence of harmonized EC rules, the authors would support the introduction of an EC regulation that deals with the most important issues of double taxation relief or, if a regulation is not feasible, a multilateral Community tax treaty. This would reduce the negative consequences of the existing web of different bilateral tax treaties between the Member States.

In the current state of affairs, however, the authors respect the view that, until a Community instrument comes into existence, the OECD Model should play a larger role in resolving the international tax disputes which result in horizontal discrimination. In the past, the ECJ applied and interpreted the OECD Model specifically to resolve international tax problems.[2] In later cases, the ECJ moved away from this approach and considered only the applicable tax treaty; the problem of horizontal discrimination therefore increased.

## 2. Domestic Legislation at Issue

Fiscal investment institutions (FIIs) are Dutch resident investment companies that allow their shareholders to make joint investments. FIIs take the form of a regular Dutch company, but by opting for the FII regime, the companies are fiscally treated more favourably than other companies with the same legal personality.

The income of an FII is taxed according to special rules designed to achieve tax parity with the shareholders that make direct investments. Therefore, the dividends received by an FII from its investments are taxed at a rate of 0%. The FII must, in principle, distribute its profits within eight months after the end of its fiscal year. The dividends distributed are taxed at the level of the FII's Dutch shareholders upon distribution.

Since no corporate income tax is effectively due by an FII, it is not possible to offset the dividend withholding tax levied on the distributions to the FII by the investments. Therefore, relief for the dividend withholding tax is granted with respect to distributions to FIIs. The withholding tax levied on dividends distributed by a Dutch resident company to an FII is refunded to the FII. Dutch tax law, however, limits the amount of the relief if the FII has foreign shareholders or if it receives dividends from certain foreign investments. These restrictions on the relief were at issue in the *OESF* case. Two limits are imposed:

– the relief for the foreign withholding tax is limited to the amount a Dutch resident taxpayer would be entitled to under the tax treaty between the Netherlands and the country in which the investment is based if the investment were owned directly by the Dutch resident taxpayer; and
– the relief is granted only to the extent the shares in the FII are held by Dutch resident shareholders.

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1. Case C-194/06, [2008] ECR, not yet published.
2. See Case C-336/96, *Gilly*, [1998] ECR I-2793.

Since the amount of the relief depends on the shareholders' residence and the place of establishment of the FII's investments, the question was raised whether these conditions are in line with EC law. From this perspective, the questions regarding the compatibility with EC law were referred to the ECJ.

Before the ECJ rendered its judgement in *OESF*, the Dutch legislation in question was amended (as from 1 January 2008). Under the new rules, an FII can opt for a reduction of the withholding tax levied on dividend distributions by the FII to its shareholders. The reduction is equal to the withholding tax levied on the dividends distributed to the FII by Dutch and foreign investments in the period the company was an FII, up to a maximum rate of 15%. This rate is the dividend withholding tax rate under Dutch domestic law. The reduction of the withholding tax on distributions by the FII is reduced to the extent the foreign shareholders participating in the FII are entitled to a reduction or refund of the dividend withholding tax under a tax treaty or the tax regulation for the Kingdom of the Netherlands.

## 3. The *OESF* Case

### 3.1. The facts

OESF, a Dutch resident FII, managed a portfolio of investments in companies listed on stock exchanges in the European Union. In the year at issue, shares in OESF were held by a number of companies and individuals, most of which were resident in the Netherlands. Some shareholders, however, were resident in another EU Member State or in a third country (e.g. Switzerland).

In 1997/98, OESF received dividends from several non-resident companies, including a company resident in Germany and a company resident in Portugal. The Dutch tax authorities denied the relief for the withholding taxes levied on the dividends from Germany and Portugal because the Netherlands–Germany tax treaty did not provide a credit for the German withholding tax and because, in the year at issue, the Netherlands did not have a tax treaty with Portugal. The tax authorities excluded the German and Portuguese withholding taxes on the dividends from the calculation of the double taxation relief. The remaining relief was further reduced to the extent that shares in the FII were held by non-resident shareholders.

According to OESF, the taxpayer, both limits on the relief violate EC law. The Lower Tax Court of Amsterdam agreed with the taxpayer. The Netherlands State Secretary appealed to the Netherlands Supreme Court, which referred the case to the ECJ for a preliminary ruling.

### 3.2. The ECJ's judgement

#### *3.2.1. Restriction relating to a credit under a treaty*

The ECJ first considered the restriction under Dutch law that relief would be granted only to the extent a Dutch resident individual was entitled to the relief if it had directly owned the shares in the distributing company. The ECJ concluded that the restriction on the relief was compatible with the free movement of capital.

##### *3.2.1.1. Comparison with domestic investments: equal treatment by the Netherlands*

The ECJ found that the Netherlands treated dividends received from Dutch investments and other investments equally. Dividends received by a Dutch FII were taxed at a rate of 0%, irrespective of the origin of the dividends.

In addition, dividend distributions by a Dutch investment to an FII were subject to the dividend withholding tax. Normally, the dividend withholding tax is a pre-levy that can be offset against the corporate income tax at the level of the shareholder. Since the FII's profits were taxed at a rate of 0%, the FII could request a refund of the dividend withholding tax levied on the dividends received. Consequently, the dividends received from Dutch investments were effectively not subject to Dutch tax at the level of the FII. In order to avoid double taxation of the income by the Netherlands, the FII was entitled to a refund of the Dutch dividend withholding tax paid. The refund, however, was not made with respect to all foreign investments distributing dividends on which foreign (i.e. German and Portuguese) dividend withholding taxes were levied. The tax treatment at the level of the FII, on the other hand, was the same: the dividends were taxed at a rate of 0%. The ECJ decided that the Netherlands was not obliged to avoid double taxation for tax charges that take place only in another Member State (i.e. the corporate income tax and dividend withholding tax in Germany and Portugal). Therefore, it seemed acceptable to grant the refund to the FII only if a Dutch shareholder of the FII would have been entitled to a refund in the case of a direct investment, i.e. without using the FII vehicle.

If the Netherlands were obliged to refund the foreign withholding taxes on the dividends received from all foreign investments, this could result in a more favourable tax treatment by the Netherlands of an FII compared to a direct investment. In this case, the FII would also be entitled to a refund in situations where shareholders in a direct relationship would not be entitled to a credit or refund.

To a certain extent, the *OESF* judgement may be compared to the *Kerckhaert Morres* judgement (Case C-513/04), where the ECJ held that EC law does not oblige a Member State to grant relief for juridical double taxation if the dividends at the level of the receiving shareholder were treated the same for tax purposes as in a domestic context. In *Kerckhaert Morres*, the Belgian spouses in the case were subject to the French withholding tax on dividends received which could not be credited. The same rules applied to the Belgian spouses as applied to persons receiving Belgian dividends. The ECJ ruled that the tax treatment did not constitute an infringement of EC law because it was the consequence of the parallel application of French and Belgian domestic legislation. In other words, from a Belgian perspective, this situation was considered a disparity that should be resolved by harmonization measures.[3] Compared to the *OESF* case, a critical remark should be made. Dutch legislation provided for a differentiation since a refund was available at the FII level for domestic dividends received, but not for non-qualifying foreign dividends received. Consequently, in the authors' opinion, it is not clear that the line of reasoning in *Kerckhaert Morres* should be followed since the situations in the two cases were fundamentally different.

In addition, consistent with the authors' opinion mentioned above, the European Commission argued in *OESF* that the Netherlands should offset the foreign tax burden on the dividends received from foreign investments in the same way it would offset the domestic tax burden to which the dividends were subject. The ECJ rejected this view. The ECJ held that the Netherlands was not obliged to eliminate double taxation that is not caused by the application of Dutch law (under which the dividends received were not effectively subject to tax), but is caused by the decision of the Member State of the investment to levy a withholding tax on the dividends distributed.

Therefore, the question remains as to how double taxation in this situation should be avoided. In principle, the authors are of the opinion that the Member State of the dividend-distributing company should exempt the dividends or that, in the alternative, it is at least ensured that no double taxation arises. In line with the ECJ's judgement in the *Amurta* case, it could be argued that, as a rule, no withholding tax may be levied at all unless a bilateral tax treaty safeguards that the withholding tax can be credited in the Member State of the dividend recipient.[4] The authors are of the opinion that in a situation like OESF's, despite the lack of harmonization, the Member State of the distributing company should withdraw from taxation. With reference to Arts. 2, 3 and 293 of the EC Treaty, double taxation should, in the authors' opinion, be effectively eliminated in order to achieve the single European market. See 5.1.

#### 3.2.1.2. *Comparison with investments in other EU Member States*

In addition to the above comparison of the Dutch tax treatment of the income received from domestic investments and from EU investments (vertical discrimination/restriction), OESF contended that an alternative comparison should be made, i.e. between the Dutch tax treatment of the income received from two different EU investments (horizontal discrimination/restriction).

In this respect, OESF argued that the income from its investments in Germany and Portugal was treated less favourably compared to the income from the other EU Member States. According to OESF, this constituted an infringement of EC law because it could deter OESF from investing in the Member States whose tax treaties do not grant a tax credit for the tax on dividends to Dutch FIIs.

The ECJ considered that, in situations where there is no harmonization, it is within the competence of the Member States to define, by treaty or unilaterally, the criteria for allocating their taxing rights.

As regards tax treaties, the ECJ held that, in situations where a treaty benefit cannot be seen as separable from the rest of the treaty but contributes to its overall balance, EC law does not require that the treaty be extended to legal persons in other jurisdictions. In these situations, the parties are not in comparable circumstances so that a different tax treatment is allowed. On the other hand, there can be situations where a treaty is extended to legal persons not covered by the treaty.[5]

Under the legislation at issue in the *OESF* case, the Netherlands had unilaterally extended the double taxation relief for OESF to the income received from investments in jurisdictions with which the Netherlands had a tax treaty. Under EC law, there is no obligation to grant double taxation relief as if the FII did not exist, resulting in a better tax position for the FII compared to the domestic dividends received by OESF, but EC law does not prevent a Member State from granting such a benefit.[6] Under these circumstances, it must be examined whether the resulting different treatment of the investments in Germany and Portugal and the investments in the other EU Member States constitutes an infringement of the free movement of capital. The ECJ held that the different treatment in principle is a prohibited restriction on the free movement of capital.

In the specific circumstances of the *OESF* case, however, the infringement could be justified because, in the ECJ's view, the situations of the shareholders investing directly in Germany, Portugal and the other Member States were not objectively comparable. The reason for this was that the rationale of the law is to treat direct investments the same as investments via an FII. Investments via an FII may not be discouraged by not allowing them to benefit from the double taxation relief that would be granted with respect to direct investments. Dutch resident taxpayers making a direct investment in German or Portuguese shares cannot credit the withholding tax on the investment under a treaty as they could with respect to a direct investment in shares in the other Member States;

3. In his opinion in *Kerckhaert Morres*, Advocate-General Geelhoed opined that there was no infringement since the net dividends from French sources were – because the *avoir fiscal* was granted – greater than the dividends from Belgian sources.
4. Case C-379/05, *Amurta*, [2007] ECR I-9569; in Paras. 78-79, the ECJ ruled: "Accordingly, the Kingdom of the Netherlands cannot rely on the existence of a tax advantage granted unilaterally by another Member State in order to escape its obligations under the Treaty. However, it cannot be excluded that a Member State may succeed in ensuring compliance with its obligations under the Treaty through the conclusion of a convention for the avoidance of double taxation with another Member State." The authors note that if a withholding tax were levied in a domestic situation, the withholding tax could also be levied in a cross-border situation, provided the levy is not otherwise contrary to the EC Treaty freedoms or the Parent-Subsidiary Directive.
5. Case C-307/97, *Compagnie de Saint-Gobain*, [1999] ECR I-6161.
6. The authors again refer to the fact that the FII would receive the same refund a shareholder would have received if the shareholder had invested directly in the investments held by the FII.

thus, in the ECJ's view, the situations are not objectively comparable. Consequently, the ECJ held that the Netherlands was not obliged to extend the relief to the investments in Germany and Portugal.

### *3.2.2. Resident shareholders*

The ECJ also examined the other limitation on the relief. The amount of the relief was also limited to the extent the FII had non-resident shareholders. In this respect, the ECJ ruled that the Dutch legislation was incompatible with the free movement of capital.

Because of the restriction, the total amount of the relief was limited based on the residence of the shareholders. This restriction was disadvantageous for all the shareholders. The total amount of the relief was reduced to the extent the shareholders were not Dutch residents, but this amount was then divided over all the shareholders irrespective of their residence. Since the Netherlands levied the dividend withholding tax on all distributions, the Dutch resident shareholders and the non-resident shareholders were considered to be in a comparable situation.

Consequently, the limitation on the double taxation relief was considered to be an obstacle for FIIs trying to raise capital from the other Member States and third countries, and the limitation restricted the ability of foreign shareholders to invest in Dutch FIIs, which is contrary to the free movement of capital. In this context, it was irrelevant whether the Netherlands had a tax treaty with the residence state of the shareholders.

## 4. Third Countries

Regarding shareholders in third countries, the ECJ held that the restriction based on the shareholders' residence could not be justified. The Netherlands argued, among other things, that the infringement could be justified because it ensured the effectiveness of fiscal supervision. The Dutch rules restricted the credit in proportion to the interests in an FII held by shareholders resident in third countries, independent of the tax treatment of the shareholders in other countries. Therefore, the effectiveness of fiscal supervision could be relied upon. The ECJ also rejected the application of the standstill provision in Art. 57(1) of the EC Treaty. This is discussed in 4.2.

### 4.1. General comments

The free movement of capital can also be applied in relation to residents of third countries. In the *OESF* case, the ECJ confirmed its position in the *A* judgement[7] that, in relation to third countries, an infringement could be justified more easily (mainly for reasons relating to the effectiveness of fiscal supervision) than infringements involving only the EU Member States.

In the absence of legislation on the exchange of information in relation to third countries, the ECJ ruled that the Member States could treat capital flows to and from third countries differently from intra-EU capital flows. According to the ECJ, the Member States should be able to assess the amount of tax liability. Since it is more difficult to determine the tax liability where third countries are involved, a more restrictive application of the free movement of capital provisions in those situations could be justified.

The *A* case concerned a Swedish shareholder of a Swiss company which considered distributing the shares in one of its subsidiaries. The Swedish shareholder (A) asked the Swedish tax authorities whether the distribution was exempt from the individual income tax. If the shares had been distributed by a Swedish company, the transaction would be exempt from the individual income tax for the Swedish shareholder. In a subsequent situation, however, the transaction was subject to tax. In the *A* case, the ECJ ruled that the Swedish legislation constituted a restriction on the free movement of capital. The ECJ, however, considered it relevant whether all the information requested for applying the exemption could be obtained from the Swiss authorities.

For a judgement in this matter, the ECJ referred the case back to the national court. Apparently, the denial of equal treatment of domestic situations and cross-border situations involving a third country can be justified if the latter situations lack a guaranteed exchange of information. Since the directives in the field of exchange of information do not apply to third-country situations, it should also be taken into account whether a bilateral tax treaty between an EU Member State and a specific third country includes a guaranteed exchange of information.

In the *OESF* case, the tax treatment in the Netherlands did not depend on the collection of information from other countries, within or outside the European Union. Under the Dutch legislation, the credit was reduced in proportion to the interests of foreign shareholders in the FII, irrespective of the tax treatment of the shareholders in the foreign countries. Consequently, the ECJ ruled that the Netherlands could not justify the restriction in the Dutch legislation based on the effectiveness of fiscal supervision.

### 4.2. Standstill provision

Finally, the Netherlands Supreme Court asked the ECJ to clarify the scope of the standstill provision in Art. 57(1) of the EC Treaty. Under the standstill provision, restrictions on the free movement of capital in relation to third countries can be justified if the restrictions existed on 31 December 1993 and involve "direct investment – including in real estate – establishment, the provision of financial services or the admission of securities to capital markets".

The standstill provision has already been subject to scrutiny by the ECJ, but in each case the ECJ clarified a different aspect of the provision.[8] In the *OESF* case, the

7. Case C-101/05, [2007] ECR I-11531.
8. See e.g. Case C-157/05, *Holböck*, [2007] ECR I-4051; and Case C-101/05, *A*, [2007] ECR I-11531.

 

Netherlands Supreme Court asked the ECJ to clarify the meaning of "direct investment". From the ECJ's current case law, it is uncertain whether "direct investment" also includes the holding of a block of shares in a company if the shares are held as a portfolio investment and the size of the block does not put the shareholder in a position to exercise a decisive influence over the management or control of the company.

The latter conditions are important in relation to the applicability of the free movement of capital provisions. In the case of concurrence between the freedom of establishment principles and the free movement of capital principles, the ECJ seems to take the approach that the freedom of establishment principles are applicable only if there is a decisive influence over the management of the company. But there are still many uncertainties in this regard. For instance, what should be the basis for deciding if there is decisive influence – should it be based on the facts and circumstances of the case or on the domestic legal provision at issue?[9] If there is no decisive influence, the free movement of capital principles seem to apply, including the standstill provision where third countries are involved.

In the *OESF* case, the ECJ concluded that a direct investment exists if the shares enable the shareholder (either under the national law relating to companies limited by shares or in another way) to participate effectively in the management of the company or in its control. According to the ECJ, the term "direct investment" includes investments of any kind made by individuals or legal persons which serve to establish or maintain lasting and direct links between the investors providing the capital and the undertakings to which the capital is made available to carry out an economic activity. The ECJ referred the *OESF* case back to the Netherlands courts for a factual determination of whether OESF qualified as a direct investment.[10]

## 5. Comments and Consequences

### 5.1. Single European market approach

The ECJ rejected the equal treatment of the FII with respect to the investments in Portuguese and German companies and the investments in other EU companies. The ECJ based its decision, not on what the authors call horizontal discrimination, but mainly on the fact that, in situations involving a *direct* investment, the Dutch shareholders also did not receive advantages. Consequently, the ECJ seemed to have accepted a difference in the tax treatment based on the applicable double taxation treaty (or the lack thereof).

This plausible reasoning of the ECJ is somewhat unusual. It goes without saying that when the ECJ compares the situation of an FII to the situation of a direct investment held by a shareholder, no horizontal discrimination is at issue because the situations are not comparable. On the other hand, it is clear that if a Dutch individual shareholder invests in both a Portuguese corporation and a Belgian corporation, the tax treatment will be different based on the place of the investment. And because investments should be treated equally within the EU, horizontal discrimination is at issue here. Consequently, in the authors' opinion, the discussion of this situation still involves horizontal discrimination.

In support of its decision, the ECJ reasoned that there is still no harmonization in the field of double taxation relief. The consequence of this reasoning is that "systems" are rewarded for their inaction. The problem the ECJ wanted to solve was the problem which arose because the Member States have not concluded a multilateral tax treaty based on Art. 293 of the EC Treaty (or former Art. 220 of the EEC Treaty). Because of the acceptance of infringements in horizontal situations, the economic parties will suffer from unequal treatment and thus from an unequal playing field in the Member State in which they want to invest. It becomes even worse because the Member States can actually restrict their market for economic players from (some of) the other Member States by agreeing on certain terms in their tax treaties. A real single European market is therefore an illusion with respect to one of the important factors in Art. 2 of the EC Treaty, which provides:

> The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing common policies or activities referred to in Articles 3 and 4, to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States.

According to Art. 3 of the EC Treaty, the following should be achieved:

> For the purposes set out in Article 2, the activities of the Community shall include, as provided in this Treaty and in accordance with the timetable set out therein:
> ...
> (c) an internal market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital;
> ...
> (h) the approximation of the laws of Member States to the extent required for the functioning of the common market.

Art. 293 of the EC Treaty provides:

> Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals:
> – ...,
> – the abolition of double taxation within the Community,
> – ....

9. Case C-492/04, *Lasertec*, [2007] ECR I-3775.
10. On 9 January 2009, the Netherlands Supreme Court ruled in Case No. 40,037 that, also in relation to third countries, the limitation based on the shareholder's residence cannot be maintained. The Court based its judgement on the reasoning that a participation in an investment institution does not relate to establishing or maintaining permanent and direct relations between the participant and the FII.

Taxation is not mentioned as one of the elements of the common market, but it is obvious that taxation is part of the internal market mentioned in Art. 3(c) and part of the approximation of the laws mentioned in Art. 3(h) of the EC Treaty. Support for the position that taxation falls within the scope of Art. 3(c) can be found in the case law of the ECJ regarding non-discrimination. In the non-discrimination cases, the ECJ said that, although harmonization can take place only if all the Member States agree, this does not mean that the Member States can deny the consequences of the four freedoms within the single European market.[11]

With respect to Art. 3(h), the same conclusion can be drawn based mainly on Art. 293 of the EC Treaty, which emphasizes the need for further harmonization. The ECJ confirmed this in e.g. the *Gilly* case[12] where it said that former Art. 220 is not intended to lay down a legal rule directly applicable as such, but merely specifies a number of matters on which the Member States are to enter into negotiations with each other "so far as is necessary". In *Gilly* (Para. 15), the ECJ also said that the second indent of Art. 293 merely indicates the abolition of double taxation within the Community as an objective of any such negotiations.

### 5.2. Effects of horizontal discrimination

Due to a lack of harmonization regarding the avoidance of juridical double taxation, the Member States are entitled to conclude bilateral tax treaties to avoid such double taxation. But even though the Member States may conclude treaties, the treaties may not violate the principles of EC law.[13] EC law should therefore be taken into account during treaty negotiations.

If, however, a treaty provision does not deal with the avoidance of double taxation by the allocation of taxing rights, in the authors' opinion, such a provision, if it is discriminatory in relation to residents of third Member States, may not be justified on the ground that double taxation relief is at stake. Therefore, if a treaty contains a provision granting favourable treatment to a company resident in the other contracting Member State but the favourable treatment is not granted to companies resident in a third Member State under the tax treaty with the third Member State, the provision should, to this extent, be considered to be incompatible with EC law. Such provisions harm the internal market because they grant rights to residents of another state which are not necessarily applicable in relation to residents of a third Member State if the tax treaty applicable to residents of the third state does not contain a comparable provision.[14] Since residents of all Member States should be treated equally under EC law, the advantages granted bilaterally should be considered incompatible with EC law.

In the authors' opinion, also in the *OESF* case, Dutch law violates the agreements which constitute the EEC/EC Treaty, namely, that the Member States are sovereign in establishing their own direct tax system and that they can compete based on domestic tax regulations. The ECJ has consistently confirmed the Member States' sovereignty as regards direct taxation, provided their tax system does not violate the free movement principles of the EC Treaty.

A Member State that levies tax on undertakings because, in that Member State's view, the taxation in the other Member State is not sufficient violates the sovereignty principle.[15] Besides vertical sovereignty (the Member States are sovereign in relation to the EC), there is what the authors call horizontal sovereignty (the Member States are also sovereign in relation to each other). In the authors' opinion, horizontal sovereignty is based on the principle of Community loyalty, as provided in Art. 10 of the EC Treaty. This principle is severely infringed if a Member State establishes a tax system but actually "punishes" the other Member States that have a tax system which the Member State does not support. It has been decided many times that a Member State may not impose its taxing standards on the other Member States by the treatment it accords to its resident companies or by treating a domestic company differently based on the residence of its subsidiaries or investments. In tax cases, the Member States always refer to their sovereign right to determine their direct tax system. The ECJ has accepted the right of the Member States to establish their own tax system under the above conditions. But if a Member State insists that differences in tax systems may exist and if the rules described in Art. 10 of the EC Treaty are taken into account, it is clear that, as the ultimate consequence, the Member States must respect the choice of the other Member States to implement a different system. The Member States must also accept that they may not treat their own companies differently based on the residence of the subsidiaries. The discussion below further considers the ECJ's line of reasoning that certain advantages granted in bilateral tax treaties cannot be regarded as separable from the rest of the treaty, but are an integral part of the treaty and contribute to its overall balance.

### 5.3. Role of the OECD Model

In the past, the ECJ has indicated that, due to a lack of harmonization, the Member States may conclude bilateral tax treaties with each other. The ECJ, however, referred to the OECD Model for the interpretation of individual treaty provisions and definitions. The ECJ's

11. The four freedoms are the elaboration of the internal market principle in specific situations. In tax cases, reference will usually be made to the internal market, which is based on Art. 3 of the EC Treaty. According to the case law of the ECJ, taxation can also implicitly be based on Art. 3. For the parallel application of Art. 3 and another EC Treaty principle, see e.g. Case C-379/92, *Peralta*, [1994] ECR I-3453 and Case 6/72, *Continental Can*, [1973] ECR I-215 (both concerning the simultaneous application of Art. 3(f) on transport policy).
12. Case C-336/96, *Gilly*, [1998] ECR I-2793.
13. Case C-307/97, *Compagnie de Saint-Gobain*, [1999] ECR I-6161, Paras. 56-57; Case C-379/05, *Amurta*, [2007] ECR I-9569, Para. 24.
14. See van den Hurk, Hans and Jasper Korving, "The '*D*' Case against the Netherlands and the ECJ's Decision – Is There Still a Future for MFN treatment?", *Bulletin for International Taxation* 8/9 (2006), at 365, 371.
15. Case C-494/03, *Senior Engineering Investments*, [2006] ECR I-525.

 

reference to the OECD Model is appropriate since most of the EU Member States are members of the OECD.[16] The ECJ seemed to consider relevant that the provisions of the OECD Model and its Commentaries are internationally accepted. Specifically, the ECJ phrased its 1998 judgement in *Gilly*, Case C-336/96, as follows:

> 30. Although the criterion of nationality appears as such in the second sentence of Article 14(1) for the purpose of allocation of fiscal jurisdiction, such differentiation cannot be regarded as constituting discrimination prohibited under Article 48 of the Treaty. It flows, in the absence of any unifying or harmonising measures adopted in the Community context under, in particular, the second indent of Article 220 of the Treaty, from the contracting parties' competence to define the criteria for allocating their powers of taxation as between themselves, with a view to eliminating double taxation.
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> 31. Nor, in the allocation of fiscal jurisdiction, is it unreasonable for the Member States to base their agreements on international practice and the model convention drawn up by the OECD, Article 19(1)(a) of the 1994 version of which in particular provides for recourse to the paying State principle. According to the commentary on that article, that principle is justified by "the rules of international courtesy and mutual respect between sovereign States" and "is contained in so many of the existing conventions between OECD member countries that it can be said to be already internationally accepted".
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> 32. In the present case, the first sentence of Article 14(1) of the Convention reproduces the tenor of Article 19(1)(a) of the OECD model convention. It is true that under the second sentence the paying State principle is abandoned where the taxpayer has the nationality of the other contracting State without being at the same time a national of the first State, but the same type of exception, based at least in part on the criterion of nationality, is found in Article 19(1)(b) of the model convention in cases where the services are rendered in the other contracting State and the taxpayer is a resident of that State who "(i) is a national of that State; or (ii) did not become a resident of that State solely for the purpose of rendering the services".

From the *Gilly* judgement, it appears that the ECJ considers the OECD Model and its interpretative Commentaries of overriding importance in international tax discussions. In *Gilly*, the Germany–France treaty seemed to be in line with the internationally accepted standards for the avoidance of double taxation. As a starting point, the ECJ appeared to be of the opinion that the OECD Model was the basis for the avoidance of double taxation within the internal market. The ECJ tested whether the provisions of the Germany–France treaty were internationally acceptable by, among other things, referring to the OECD Model and its Commentaries. The comparison of a bilateral treaty with the OECD Model – or the acceptability of a bilateral treaty provision based on its conformity with the OECD Commentaries – was also made later by the ECJ.[17]

In *Gilly*, the ECJ derived the measure of acceptability of the bilateral treaty provisions from the OECD Commentaries. Relying on the Commentaries, the ECJ said that, because a specific interpretation is accepted by so many OECD countries – and thus by the EU Member States – it can be concluded that a particular provision is internationally accepted. Consequently, the ECJ tried to find a common interpretation for international tax disputes and, in this respect, referred to the OECD Model since it is regularly used as the basis for treaty negotiations, also by the EU Member States. From a practical point of view, therefore, the provisions of the OECD Model may be regarded as an international standard. This does not mean that only the OECD Model is key. Any treaty could be relevant, provided its provisions are internationally accepted.

In the later judgements of the ECJ, the reference to the OECD Model was gradually removed. At first, the ECJ referred to the OECD Model only as the basis for treaty negotiations between the EU Member States.[18] These cases did not specifically concern the interpretation of bilateral tax treaty provisions in relation to the internationally accepted approach of the OECD Model, but the sliding scale had begun. Thereafter, the ECJ said that it is not unreasonable for the Member States to find inspiration in international practice and particularly in the OECD Model.[19] From then on, it was a small step for the ECJ to refer to the OECD Model only as a source of law when a specific bilateral tax treaty was concluded, instead of referring to the OECD Model as the basis for avoiding double taxation.[20] In some cases involving bilateral tax treaties, no reference was made at all to the OECD Model, not even in relation to the international acceptability of the bilateral treaty provisions.[21]

Based on this case law of the ECJ, in which the ECJ considered the OECD Model to be increasingly less important, a problem slowly arose. Since the ECJ considered individual bilateral tax treaties to be more important, differentiations become more eloquent because treaty provisions were not harmonized within the EU. In other words, the Member States could grant more favourable treatment in their treaties with certain other Member States without the obligation to grant the same favourable treatment in their bilateral tax treaties with all the other Member States. Consequently, the sliding scale in the ECJ's case law actually made horizontal discrimination possible.

What was the ECJ's reason for creating more distance between the OECD Model and specific bilateral tax treaties? The initial position as developed in *Gilly* would have led to more unity within the internal market, but the ECJ seems to have created much uncertainty by referring each time to individual treaties, which are only single threads in a large web. The authors are of the opinion that, as long as there are no harmonization measures, the ECJ should go back to basics, back to *Gilly*, and back to the OECD Model and its Commentaries in dealing with international tax problems. If the ECJ did this, the

16. The following Member States are not member of the OECD: Bulgaria, Cyprus, Estonia (candidate country to the OECD), Latvia, Lithuania, Malta and Romania.
17. Case C-436/00, *X and Y*, [2002] ECR I-10829.
18. Case C-136/00, *Danner*, [2002] ECR I-8147; Case C-324/00, *Lankhorst-Hohorst*, [2002] ECR I-11779.
19. Case C-513/03, *van Hilten-van der Heijden*, [2006] ECR I-1957.
20. Case C-524/04, *Test Claimants in the Thin Cap Group Litigation Order*, [2007] ECR I-2107; Case C-414/06, *Lidl Belgium*, [2008] ECR, not yet published.
21. Case C-152/03, *Ritter-Coulais*, [2006] ECR I-1711; Case C-376/03, *D*, [2005] ECR I-5821; Case C-527/06, *Renneberg*, [2008] ECR, not yet published.

problem arising from the integral examination of bilateral treaties would no longer be an issue. This is an important advantage because the ECJ's refusal to test a particular tax treaty provision is unacceptable for taxpayers from the perspective of a single European market, although the authors are aware of the difficulties faced by the Member States in concluding tax treaties and the consequences of the "give and take" that is part of the process. If the OECD Model were the only accepted source of law for the ECJ, the burden would be more equally divided among all the Member States and therefore among taxpayers. In the end, however, harmonization should take place.

### 5.4. Harmonizing the rules for the avoidance of double taxation

Creating a single European market in the field of direct taxation seems to be one of the most difficult challenges within the European Union. For this reason, the harmonious treatment of international tax conflicts within the internal market by the ECJ's approach in *Gilly* would be a good first step. Using the OECD Model as the basis for granting double taxation relief and resolving related problems would be a harmonious approach to international tax disputes. In this respect, however, it should be noted that if the ECJ again referred specifically to the provisions of the OECD Model, bilateral treaties would still be relevant in international taxation for the EU Member States.

With respect to horizontal discrimination, reference to the OECD Model would mean the establishment of a real internal market regarding one of the main issues – double taxation relief. The internal market would work as a real single market because there would no longer be any differences in the double taxation relief for the residents of a particular Member State, i.e. the relief would not depend on the other Member States in which the residents invest. For these reasons, accepting the OECD Model as a common instrument for resolving international tax disputes is a solution for the future – until other harmonization measures come into effect. The advantage of this solution is that it can be based on the case law of the ECJ.

This approach would in principle have no consequences for the rights of residents of the Member States applying bilateral treaty provisions. Or this approach would at least not be disadvantageous to such residents. If horizontal discrimination arises in a situation governed by a bilateral tax treaty that conforms with the OECD Model, the internationally accepted provisions of the OECD Model will be followed, effectively resulting in the setting aside of the four freedoms. If, however, the bilateral tax treaty is not based on the OECD Model, or on other internationally accepted principles, and horizontal discrimination arises, an appeal to the four freedoms should be successful to abolish the horizontal discrimination. But since the law is not black or white and since no bilateral tax treaty conforms fully with the OECD Model, the authors are of the opinion that there still is a large grey area – and for this reason harmonization is of utmost importance. The grey area will lead to many discussions, and probably to litigation.

Even in this grey area without an independent application of the OECD Model, the OECD Model and its Commentaries can still be used to interpret existing tax treaties as much as possible in line with the OECD Model.

As a problem under this scenario (direct application of the OECD Model), the authors foresee that the EU Member States would depend not only on the acceptance of the other Member States, but also on the acceptance and cooperation of the other OECD countries. This would be less of a problem, however, if the OECD Model is used only as a means of interpretation.

In addition, practical problems could arise if e.g. some Member States deviate from specific provisions of the OECD Model or the Commentaries. The current origin of these problems is the ECJ's approach. The problems could preferably be resolved by the European Commission through the introduction of a regulation on the avoidance of double taxation. If such a regulation were introduced and accepted by the Council, a specific reference to the OECD Model[22] would no longer automatically be made, but there would be a harmonized Community measure.

One of the most important advantages of a harmonized approach is that horizontal discrimination would no longer exist.[23] The harmonized approach should include only rules for the avoidance of double taxation and the allocation of taxing rights. But more general rules could also be included, i.e. provisions on residence and beneficial ownership. Another advantage of this approach is that the definitions would have a Community meaning, resulting in the harmonized interpretation of the definitions. This would lead to further integration within the single European market and to simpler discussions in an international context.

The political discussion resulting from the above should only be about the most appropriate form of a harmonized EU-wide measure for avoiding double taxation. Should the form be a multilateral EU tax treaty or a regulation?[24] The authors prefer the latter since a regulation would harmonize the most relevant elements. In addition, the effect could be that the individual Member States do not exchange specific advantages in their bilateral treaties. The regulation would have direct effect in the legislation (and international practice) of all the Member States. This would be the most neutral way of finally solving the problems arising from the web of bilateral tax treaties and the distortions and disparities resulting from them.

22. I.e. both the version of the OECD Model applicable when a state joins the European Union and later changes to the OECD Model.
23. See van den Hurk and Korving, supra note 14.
24. Art. 293 of the EC Treaty contains only the objective that double taxation within the EU should be avoided; it does not prescribe the form of a harmonized measure. Consequently, this could take the form of either a regulation or a multilateral treaty.

 

## 6. Conclusion

In *Orange European Smallcap Fund*, the taxpayer was partly put right by the ECJ. The refund of the withholding tax could be limited based on place of establishment of the investments distributing the dividends to the FII, but no further reduction was allowed based on the residence of the shareholders. As mentioned above, the Dutch legislation was amended before the ECJ's judgement in *OESF*. Whether the amended legislation is in line with EC law should be clarified in the near future.

The more important – and actually implicit – consequence of *OESF* relates to horizontal discrimination. The dividends received from investments in one Member State were treated differently from the dividends received from investments in another Member State. In the authors' opinion, this does not contribute to the Community objective of an internal market in which there is no differentiation based on the residence of a company.

With reference to the ECJ's case law, starting with *Gilly*, the authors expressed the view that the ECJ should go back to basics in its approach to horizontal discrimination. In the past, the OECD Model was considered relevant to determining the international acceptability of a specific bilateral treaty provision, and this practice should return. It would promote the effectiveness of the single European market. In its more recent cases, the ECJ seemed to refer only to the bilateral treaty provision at stake, without examining whether the provision was compatible with international practice.

The reference to the OECD Model would only be a helpful prelude to a more harmonized approach by the Council. The authors expressed their wish for a Community regulation or a multilateral tax treaty to resolve the main double taxation disputes between the EU Member States. The internal market would greatly benefit from harmonization since double taxation would be abolished in the vast majority of cases. But the discussions on harmonization will not be over until the "fat lady sings".