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The Limitation on Benefit Clause of the U.S.-German Tax Treaty and its Compatibility with European Union Law

Dietmar Anders

COMMENTS

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*Dietmar Anders**

* Attorney in Munich, Germany. Dr.iur. (S.J.D.) Candidate, University of Munich; LL.M., Northwestern University, 1997; Assessor, Supreme Court of Bavaria, 1995; Referendar (J.D.), University of Munich, 1993.

I. INTRODUCTION

Although the U.S.-German Double Tax Treaty[1] generally proves valuable for both U.S. and German companies, one of its main provisions is contrary to European Union law. The so-called "limitation on benefits" clause in this Treaty requires companies seeking relief from double taxation to be at least fifty percent held by German or U.S. nationals.[2] This clause is intended to prevent nationals of non-Treaty countries from abusing the treaty benefits by establishing conduit companies in the contracting states. Although such clauses exist in many treaties, this clause is inappropriate in the U.S.-German Treaty because it results in discriminatory treatment of corporations in Germany that are not majority-owned by German or U.S. nationals. This discriminatory treatment conflicts with the freedom of establishment, as guaranteed by the EC Treaty,[3] if the owners who disqualify the company from the U.S.-German Treaty are nationals of Member States of the European Union.[4] The limitation on benefits clause makes the investment in a company in Germany less attractive for EU nationals because the company will not receive Treaty benefits and will face a higher tax rate in its German tax bill.

This comment details why the limitation on benefits clause of the U.S.-German Treaty is contrary to European Union law.[5] Part I describes the discriminatory situation which German companies may face and illustrates how tax treaty abuse could occur and how to prevent it. Part I also contains an introduction to the U.S.-German Treaty and provides an example of the conflict between U.S. tax treaties and European Union law. Part II analyzes in detail the Treaty's discriminatory features with respect to European Un-

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[1] Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Aug. 29, 1989, U.S.-F.R.G., S. TREATY DOC. NO. 101-10 (1990), *reprinted in* 2 Tax Treaties (CCH) ¶ 3249 [hereinafter U.S.-German Treaty, or Treaty]. The Treaty was brought into force on August 21, 1991 and became generally effective on and after January 1, 1990. On the same date, a Protocol to the Treaty and a Technical Explanation were signed. Protocol to the Treaty, Aug. 29, 1989, *id.*, ¶ 3250 [hereinafter Protocol]; Treasury Department Technical Explanation, *id.*, ¶ 3255 [hereinafter Technical Explanation]. The present Treaty replaced the prior Treaty of 1954. Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income, July 22, 1954, U.S.-F.R.G., *reprinted in* 3 Tax Treaties (CCH) ¶ 12,471.

[2] *See* U.S.-German Treaty, *supra* note 1, art. 28(1)(e), ¶ 3249.57.

[3] *See* TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Feb. 7, 1992, O.J. (C 224) 1 (1992), [1992] 1 C.M.L.R. 573 (1992) [hereinafter EC TREATY]. The EC Treaty is based on the TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY, Mar. 25, 1957, 298 U.N.T.S. 11, and amended and renamed by the Single European Act, 1987 O.J. (L 169) 1, and the TREATY ON EUROPEAN UNION, Feb. 7, 1992, 1992 O.J. (C 224) 1, [1992] 1 C.M.L.R. 573. The freedom of establishment is guaranteed in Article 52. EC TREATY art. 52.

[4] Hereinafter European Union, EU, or Community.

[5] As used in this comment, "European Union law" encompasses both the European Court of Justice's case law and law established by the EC Treaty.

ion law and discusses potential justifications for this discrimination based on the case law of the European Court of Justice.[6] Part II concludes that the limitation on benefits clause constitutes unjustified discrimination and violates the EC Treaty. Part III reflects on possible solutions to the conflict, and it recommends a renegotiation of the U.S.-German Treaty. At present, an implementation of the derivative benefits concepts into this Treaty is advisable. However, Part III recommends that all bilateral treaties between the United States and EU Member States should later be replaced by a single tax treaty between the United States and the European Union. Part IV summarizes the conclusions drawn in Parts I-III.

A. The Discriminatory Situation for German Companies under the U.S.-German Treaty

The following situation could occur in the context of the U.S.-German Treaty. A parent company[7] in Germany operates a subsidiary in the United States. The German company receives dividends from its U.S. subsidiary. The dividends are subject to U.S. and German income tax. In the United States, those dividends are subject to a thirty percent withholding tax because they are paid by a U.S. domestic corporation to a non-resident of the United States.[8] Those same dividends are also subject to German income

[6] The European Court of Justice, hereinafter Court of Justice, or Court, is one of the main institutions of the European Union, together with the European Parliament, the Council, the Commission, and the Court of Auditors. EC TREATY art. 4. The Court's task, as laid out in Articles 164-188 of the EC TREATY, is to observe the interpretation and application of European Union law, in addition to the judiciaries of the Member States. EC TREATY arts. 164-68. Therefore, the compatibility of the U.S.-German Treaty clause with European Union law is determined by the EC Treaty as interpreted and applied by the Court. The Court's decision-making is prepared and assisted by Advocates General acting as *amici curiae*. EC TREATY art. 166. The opinions submitted by the Advocates General sometimes contain authoritative legal analysis which is not expressly reproduced in the Court's judgment. Those opinions are hereinafter cited as "Opinion {*name*}."

[7] In this comment, the term "company" serves as a general term representing any form of union or association of persons carrying on a commercial or industrial enterprise. *See, e.g.*, BLACK'S LAW DICTIONARY 281 (6th ed. 1990). *See also* EC TREATY art. 58. In most cases, however, a German company seeking treaty benefits will preferably be set up as a German corporate entity. This is due to general choice of entity considerations but the foremost reason is that a corporation is a separate entity for tax purposes. *See* U.S.-German Treaty, *supra* note 1, art. 3(1)(e), ¶3249.07 (defining company as "any body corporate"). Under German law, two types of corporations are relevant: the *Gesellschaft mit beschränkter Haftung* [GmbH] and the *Aktiengesellschaft* [AG]. Where the term "shareholder" is used in this comment, it refers to the publicly traded shares of the AG. However, the same issues are applicable to holders of an interest in a GmbH because the wording of the Treaty uses the general term "interest". U.S.-German Treaty, *supra* note 1, art. 28(1), ¶ 3249.57.

[8] *See* I.R.C. § 871(a), § 881 (CCH 1997). An exception to this rule occurs where the dividend is not subject to withholding tax if, apart from other requirements, at least 80% of the domestic corporation's gross income is foreign source business income. I.R.C. § 871(i).

tax.[9] In this situation, the German parent profits twice under the U.S.-German Treaty. First, the Treaty provides relief from double taxation by allowing the parent to apply the German tax exemption method with respect to its dividend income.[10] Second, the dividends, paid by a subsidiary to its parent, are eligible for a lower five percent U.S. withholding tax rate under the Treaty.[11]

An abuse of the U.S.-German Treaty would occur in this situation if a resident of a third country that has not concluded a tax treaty with the United States imitates this construction and interposes a German company between itself and the United States. This German corporation, which acts as a mere conduit, would fall within the ambit of the Treaty and would receive the preferential tax rate of five percent established by the Treaty although its owners have no connections to the United States, Germany, or to the Treaty. To prevent this abuse, the German company intending to take advantage of the lower Treaty tax rate must satisfy several qualifications. Article 28(1)(e)(aa) of the U.S.-German Treaty, the so-called ownership percentage test, requires that a German company be owned by at least fifty percent German or U.S. nationals before the company enjoys the treaty benefits.[12] Thus, a German company does not qualify for the Treaty if, for example, sixty percent of its shareholders are French nationals, and forty percent are German nationals. Such a company would receive, after taxes, only seventy percent of the subsidiary's dividend instead of the ninety-five percent it would receive if the preferential rate under the Treaty were applied. Additionally, the dividend income is not excluded from German tax but does, however, receive a credit or deduction allowance for the U.S. income tax paid.[13] This treatment results in a higher overall tax burden for the disqualified company.[14]

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[9] *See* Einkommensteuergesetz [Income Tax Code] [EStG] § 20(1) Nr. 1. The income consisting of dividend payments is part of the gross income. EStG §§ 2(1) Nr. 5, 2(2) Nr. 2.

[10] *See* U.S.-German Treaty, *supra* note 1, art. 23(2)(a), ¶ 3249.47. If the parent holds less than 10% of the voting shares of the subsidiary, the Treaty only allows a German tax credit against the U.S. tax paid. U.S.-German Treaty, *supra* note 1, art. 23(2)(b)(aa), ¶ 3249.47.

[11] *See* U.S.-German Treaty, *supra* note 1, art. 10(2)(a), ¶ 3249.21.

[12] *See* U.S.-German Treaty, *supra* note 1, art. 28(1)(e)(aa), ¶ 3249.57.

[13] *See* EStG, *supra* note 9, § 34c(1), (2).

[14] In turn, this also economically affects the company's dividends to its shareholders. However, the entity which is legally affected by the disqualification is the company liable to tax, not its shareholders.

B. The Prevention of Tax Treaty Abuse

1. The Role of Tax Treaties

Tax treaties are established to avoid the problem of international double taxation.[15] Double taxation occurs when the same income is taxed twice.[16] Such situations often result at the international level when more than one country has a claim to tax the same income. The problem arises especially if a country levies taxes upon its nationals on a worldwide basis instead of on a territorial basis.[17] In international transactions, one country's territorial claim to tax may coincide with another country's claim based on citizenship or residency.[18] The taxpayer then must pay taxes twice, unless a country's national law or a double tax treaty provides relief.

Tax treaties seek to alleviate or eliminate this double taxation.[19] For this purpose, most treaties apply to individual and corporate income taxation.[20] A country's economic rationale to enter into a treaty and build a network of tax treaties is two-fold. On a macroeconomic level, countries intend to abolish discrimination against international trade and to encourage cross-border investments. With respect to each taxpayer, however, treaties lessen the excessive individual burden of being taxed twice which may be unfair and unjust. Treaties also provide a higher degree of predictability and certainty for individuals planning their tax environment because treaty obligations tend to restrict the contracting states' ability to change their domestic tax law.[21]

Tax treaties are international law obligations that modify the existing national tax law regimes of the involved countries.[22] They typically classify

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[15] Such treaties are mostly bilateral, sometimes multilateral, agreements between independent nations on the level of international public law. *See, e.g.*, BLACK'S LAW DICTIONARY 1502 (6th ed. 1990).

[16] *See, e.g.*, 2 PHILIP F. POSTLEWAITE & TAMARA L. FRANTZEN, INTERNATIONAL TAXATION § 14.05 (2d ed. 1996).

[17] Both the U.S. and the German systems of taxation follow the approach of worldwide income taxation. This means that their nationals and residents are generally subject to tax on all items of their income regardless of where their income is earned. Most other countries, however, restrict themselves to taxation of income earned within their territories.

[18] For example, earnings may be subject to U.S. income tax due to the recipient's U.S. citizenship. Yet, this same income may also be subject to a foreign income tax because it is earned in a foreign country.

[19] *See* POSTLEWAITE & FRANTZEN, *supra* note 16.

[20] The U.S.-German Treaty, for example, covers the U.S. federal income taxes imposed by the Internal Revenue Code, the excise tax imposed on insurance premiums, and the German individual income tax, corporation tax, trade tax, and capital tax. U.S.-German Treaty, *supra* note 1, art. 2(1), ¶ 3249.05.

[21] *See* POSTLEWAITE & FRANTZEN, *supra* note 16. However, unilateral changes in domestic tax law can occur, even if these changes are in conflict with prior treaty obligations. See *infra* note 69 for a discussion of "treaty override."

[22] *See* POSTLEWAITE & FRANTZEN, *supra* note 16.

specific types of income.[23] For each class of income, one country waives the right to tax, and the authority to tax is assigned to the other country. The reassignment of taxing authority is generally made with reference to the source of the income because the source of income most closely reflects the economic structure of transactions. In addition, treaties often reduce the applicable tax rate.[24] As a result, a specific type of income may be taxed only in one of the contracting states, at the regular or a lower tax rate, or the income may not be taxed at all.

Most countries also offer relief from double taxation under their national tax laws.[25] This relief can be accomplished by exempting foreign source income,[26] granting a tax credit for foreign taxes paid,[27] or allowing a deduction as an expense for foreign taxes paid.[28] Yet, these rules are not in addition to a tax treaty relief regime. Instead, they are usually applied in cases in which no applicable tax treaty is in force.[29] As purely domestic measures they are unilateral and often cannot resolve international tax conflicts in the absence of tax treaties.[30]

2. *Limitation on Benefit Clauses as a Prevention to Tax Treaty Abuse*

Tax treaties are advantageous to taxpayers because they reduce or eliminate tax burdens that would persist in the absence of such treaties. Such advantages, however, may promote the abuse of treaties. Individuals from countries that have concluded no, or only unfavorable, tax treaties often feel encouraged to take advantage of a tax treaty between other countries that is not normally available to them.[31] In order to do this, a corporation or an individual in a non-treaty country will form an entity in a treaty country to take advantage of preferential tax treatment and then funnel the profits back to the non-treaty country. This pattern is often referred

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[23] *See, e.g.*, U.S. Department of the Treasury, United States Model Income Tax Convention of September 20, 1996, art. 6-21, *reprinted in* 1 Tax Treaties (CCH) ¶ 214 [hereinafter U.S. Model Treaty].

[24] *See id.*

[25] *Id.*

[26] *See, e.g.*, I.R.C. § 911(a).

[27] *See, e.g.*, I.R.C. § 901(a).

[28] This method is not acknowledged under U.S. tax law. German tax law, however, allows a deduction of foreign taxes paid if the taxpayer so requests. EStG, *supra* note 9, § 34c(2).

[29] *See, e.g.*, EStG, *supra* note 9, § 34c(6). The section grants double tax relief only if no double tax treaty exists with the concerned foreign country. *Id.*

[30] *See* POSTLEWAITE & FRANTZEN, *supra* note 16.

[31] There is no complete international tax treaty network. Many countries have no tax treaties due to their less-developed tax systems or for political reasons. Others have terminated existing treaties. *See* Andre Fogarasi et al., *Current Status of U.S. Tax Treaties*, 26 TAX MGMT. INT'L J. 139 (1997) (listing current U.S. treaties).

to as "treaty shopping."[32] A "conduit company" is an entity set up for the sole purpose of passing income from one country where it receives preferential tax treatment under a treaty, through to another country.

Treaty shopping can be prevented.[33] This is usually accomplished through clauses that restrict treaty benefits to few individuals and entities on the basis of their proximity to the treaty countries.[34] These clauses are called "anti-abuse" or "limitation on benefit" clauses. The clauses try to exclude mere conduits or leveraged shells from taking advantage of the treaty benefits by identifying a company's substantial business nexus to one or both contracting states.[35] From a technical point of view, those clauses may be seen as further limitations on treaty use, as well as being clauses that determine the personal scope of the treaty.[36]

The U.S. policy is generally to include limitation on benefits clauses in new or amended treaties.[37] If existing treaties do not include these clauses, the United States urges its contracting partner to renegotiate the treaty, or

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[32] *See, e.g.*, Simone Haug, *The United States Policy of Stringent Anti-treaty-shopping Provisions: A Comparative Analysis*, 29 VAND. J. TRANSNAT'L L. 191, 204-15 (1996); William P. Streng, *"Treaty Shopping": Tax Treaty "Limitation of Benefits" Issues*, 15 HOUS. J. INT'L L. 1 (1992); Bernd Wegmann, *Das "Treaty Shopping" aus US-amerikanischer Sicht*, 30 RECHT DER INTERNATIONALEN WIRTSCHAFT [RiW] 787 (1984). In a broader sense, the term "treaty shopping" comprises all attempts to reroute income through countries and thereby to reap tax treaty benefits that were otherwise unavailable. Two main methods fall under the term: The direct conduit method that uses tax exemptions in the country where the conduit is placed, and the stepping-stone method that uses the possibility of a base reduction in that country, i.e., offsetting the taxes paid in that country by transferring all profits to a third country. *See* Haug, *supra*, at 205-7.

[33] *See generally* Kenneth A. Grady, *Income Tax Treaty Shopping: An Overview of Prevention Techniques*, 5 NW. J. INT'L L. & BUS. 626 (1983); Haug, *supra* note 32, at 221-31.

[34] *See, e.g.*, U.S. Model Treaty, *supra* note 23, art. 22.

[35] As the Technical Explanation to the U.S.-German Treaty points out, the thrust of its limitation on benefits clause is to assure that the benefits are not extended to persons "not having a substantial business in, or business nexus with, the other Contracting State." *See* Technical Explanation, *supra* note 1, art. 28. Many different concepts for identifying such nexus are in use in other treaties. *See also* Streng, *supra* note 32, at 23 (listing a variety of tests that have been used in U.S. treaties).

[36] Both the personal scope and the anti-treaty-shopping clauses limit the benefits. *See, e.g.*, Richard E. Andersen, *ALI Study Recommends Changes in U.S. Tax Treaty Policy*, 2 J. INT'L TAX'N 253, 255 (1991) (considering treaty shopping prevention rules as exceptions to residence rules).

[37] *See* U.S. Department of the Treasury, Technical Explanation of the United States Model Income Tax Convention, Sept. 20, 1996, art. 22, *reprinted in* 1 Tax Treaties (CCH) ¶ 214A. Article 22 expresses that "the United States holds strongly to the view that tax treaties should include provisions that specifically prevent misuse of treaties by residents of third countries." *Id.; see also* Haug, *supra* note 32, at 238-57; H. David Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15 LAW & POL'Y INT'L BUS. 763, 779-810 (1983) (providing history of limitation on benefit clauses in U.S. treaties); H. David Rosenbloom, *Toward a New Tax Treaty Policy for a New Decade*, 9 AM. J. TAX POL'Y 77, 92 (1991) (criticizing the U.S. approach to limitation on benefit clauses as "overdoing" and suggesting that policies be rethought).

even terminates the treaty.[38] Although U.S. treaties are based on a Model Treaty,[39] treaties between the United States and European countries include such clauses with much variation in their details.[40] Due to the strong negotiating position of the United States and prior treaty history, these clauses are detailed and stringent in their attempt to avoid treaty abuse.

Under the U.S.-German Treaty, the taxpayer must overcome two hurdles in order to receive preferential tax treatment. First, the taxpayer must fall within the personal scope of the Treaty.[41] In order to meet this requirement, a corporation must be a resident of a contracting state.[42] A corporation that seeks to treaty shop easily fulfills the personal scope requirement by incorporating in a contracting state.[43] Second, the taxpayer must satisfy Article 28's limitation on benefits clause.[44]

C. The U.S.-German Treaty

An analysis of the U.S.-German Treaty's limitation on benefits clause is interesting for a number of reasons. First, the U.S.-German Treaty was the first treaty between the United States and a European country that contained an elaborate limitation on benefit clause.[45] As a result, the Treaty has been discussed extensively,[46] and this clause has served as a model for other

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[38] For example, in 1995 the United States terminated a 1980 treaty between the United States and Malta, because the 1980 treaty had no limitation on benefits provision and the two countries could not come to an agreement on that issue. Agreement Between the United States of America and the Republic of Malta with Respect to Taxes on Income, Mar. 21, 1980, U.S.-Malta, *reprinted in* 2 Tax Treaties (CCH) ¶ 5803.

[39] U.S. Model Treaty, *supra* note 23.

[40] *See, e.g.*, Monique van Herksen, *Limitation on Benefits and the Competent Authority Determination*, 50 BULL. INT'L FISCAL DOC. 19, 22 (1996) (giving an overview of different clauses used in treaties between the United States and European countries).

[41] U.S.-German Treaty, *supra* note 1, art. 4, ¶ 3249.09.

[42] *Id.*

[43] Every corporation organized under German law must specify its statutory seat in Germany. According to the "seat rule," which governs most civil law systems, a corporation is only recognized as a separate entity if its principal place of business is in the state of incorporation. *See* Werner F. Ebke & Markus Gockel, *European Corporate Law*, 24 INT'L LAW. 239 (1990). Thus, the state of incorporation, which is decisive under the "internal affairs rule" of U.S. corporate law, is only of secondary importance for the corporate status. *See also* GÖTZ HUECK, *in* ADOLF BAUMBACH & GÖTZ HUECK, GMBH-GESETZ, KOMMENTAR, Einleitung, annotation 29 (16th ed. 1996); Brigitte Knobbe-Keuk, *Umzug von Gesellschaften in Europa*, 154 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT [ZHR] 325, 326 (1990); Brigitte Knobbe-Keuk, *Niederlassungsfreiheit: Diskriminierungs- oder Beschränkungsverbot?*, 43 DER BETRIEB [DB] 2573, 2577-81 (1990); Martina R. Deckert, *Europäisches Unternehmensrecht*, 1996 ZEITSCHRIFT FÜR EUROPÄISCHES WIRTSCHAFTS- & STEUERRECHT [EWS] 265, 270.

[44] *See* U.S.-German Treaty, *supra* note 1, art. 28, ¶ 3249.57.

[45] *See id.*

[46] *See, e.g.*, Richard E. Andersen, *U.S. and West Germany Sign New Ground-Breaking Tax Treaty*, 1 J. INT'L TAX'N 60 (1990); Friedhelm Jacob, *The New German-U.S. Double Taxation Treaty*, 29 EUR. TAX'N 326 (1989); Reinhard Pöllath, *Investing in Germany under*

treaties.[47] In fact, the most recent U.S. Model Treaty contains a clause derived from the U.S.-German Treaty.[48] This comment has already noted that the clause in the U.S.-German Treaty might interfere with European Union law.[49] However, scholarship in this area has not yet examined why this clause and similar clauses in other treaties impede European Union law.

Second, a closer investigation of the clause could facilitate the design of future provisions which conform with European Union law.[50] After concluding the Treaty with Germany, the United States renegotiated and entered into treaties with other European countries. These treaties implicitly suggest that the contracting states were aware of the issue of incompatibility with European Union law because the treaties contain modified clauses in reaction to criticism about a possible infringement of European Union law by the U.S.-German Treaty. These treaties expressly deal with the role of European companies seeking treaty benefits.[51] However, some of the newly

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the New U.S.-German Tax Treaty, 2 INT'L TAX'N 175 (1991); Helmut Debatin, *Das neue Doppelbesteuerungsabkommen mit den USA* (pts. 1 & 2), 43 DER BETRIEB [DB] 598, 654 (1990); Wilhelm Haarmann, *The New Double Tax Treaty Between the Federal Republic of Germany and the United States of America*, 17 INTERTAX 269 (1989).

[47] *See, e.g.*, Joseph DeCarlo et al., *An Overview of the Limitation on Benefits Article of the New Netherlands-U.S. Income Tax Convention*, 22 TAX MGMT. INT'L J. 271 (1993); Ian K. Sugarman, *The U.S.-Netherlands Income Tax Treaty: Closing the Doors on the Treaty Shoppers*, 17 FORDHAM INT'L L.J. 776, 797 (1994). Germany, originally critical of limitation on benefits clauses, now also tends to support more stringent clauses. *See* Friedrich Hey, *New German Tax Laws Aim to Increase Investment*, 5 J. INT'L TAX'N 109, 111 (1994); Wolfgang Ritter, *The German Approach to Double Taxation Treaty Negotiations*, 19 INTERTAX 204, 209 (1991). Surprisingly, prior German treaties set an even higher threshold of qualification than the U.S.-German Treaty does. For example, a treaty with Kuwait that was signed in 1987 and entered into force in 1989 requires at least 75% of a German corporation to be owned by the state of Kuwait, and the remaining percentage to be owned by German or Kuwaiti nationals. Agreement Between the Federal Republic of Germany and the State of Kuwait for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital and for the Fostering of Economic Relations, Dec. 4, 1987, F.R.G.-Kuwait, art. 23(1), Bundesgesetzblatt [Federal Law Gazette] [BGBl.] II 1989, at 354, 637 (F.R.G.), *available in* LEXIS, Intlaw Library, TNI File, 93 TNI 92-17.

[48] *See* U.S. Model Treaty, *supra* note 23, art. 22.

[49] *See* Pöllath, *supra* note 46, at 178.

[50] *See* Luc Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law. The Rules*, 1994 EC TAX REV. 146, 164 (proposing comprehensive studies of individual treaty provisions as a preparation to renegotiation).

[51] *See* Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Aug. 31, 1994, U.S.-Fr., art. 30, *reprinted in* 2 Tax Treaties (CCH) ¶ 3001.31 [hereinafter U.S.-French Treaty]; 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, Dec. 18, 1992, U.S.-Neth., art. 26, *reprinted in* 2 Tax Treaties (CCH) ¶ 6103.28 [hereinafter U.S.-Dutch Treaty]; Convention Between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fis-

designed clauses are controversial and also may not totally conform to European Union law. For example, the new U.S.-French, U.S.-Dutch, and U.S.-Spanish treaties[52] do not seem to be fully compatible with European Union law, because their limitation on benefits clauses impose constraints on ownership by residents of the European Union.[53] Also, these treaties are problematic in terms of the exact wording, the predictability, and practicability of the complex provisions.[54] In contrast, other clauses in newly concluded treaties do not conform with European Union law, especially treaties with less influential EU countries. For example, the recently signed U.S. treaties with Portugal and Sweden, like the U.S.-German Treaty, completely ignore non-national EU shareholders where restrictions on ownership are concerned.[55] Therefore, the treatment of EU companies in U.S. limitation on benefit clauses continues to be vague and unpredictable.[56] No clear de-

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cal Evasion with Respect to Taxes on Income, Feb. 22, 1990, U.S.-Spain, art. 17, *reprinted in* 3 Tax Treaties (CCH) ¶ 8403.35 [hereinafter U.S.-Spanish Treaty].

[52] *See* U.S.-French Treaty, *supra* note 51, art. 30; U.S.-Dutch Treaty, *supra* note 51, art. 26; U.S.-Spanish Treaty, *supra* note 51, art. 17.

[53] *See* U.S.-French Treaty, *supra* note 51, art. 30; U.S.-Dutch Treaty, *supra* note 51, art. 26; U.S.-Spanish Treaty, *supra* note 51, art. 17. A company owned by a majority of EU residents can only qualify under these treaties if this EU ownership does not exceed certain maximum percentages.

[54] *See, e.g.*, Dirk van Unnik & Maarten Boudesteijn, *The New US-Dutch Tax Treaty and the Treaty of Rome*, 1993 EC TAX REV. 106; Franco Gallo & Gaetano Casertano, *The Clause Anti-abuse in the Italian Double Tax Treaties and their Compatibility with the EC Law*, 23 INTERTAX 649 (1995); Marco de Lignie, *Limitation on Benefits: Recently Signed US Treaties Compared to the 1992 US-Netherlands Treaty*, 49 BULL. INT'L FISCAL DOC. 71 (1995); van Herksen, *supra* note 39, at 19; Harrison Cohen et al., *Analysis of the New U.S.-Luxembourg Income Tax Treaty*, 25 TAX MGMT. INT'L J. 403 (1996); Peter Essers & R.H.M.J. Offermanns, *Tax Treaties in Conflict with the EC Treaty: The Incompatibility of Anti-Abuse Provisions and EC Law*, 22 I.T.J. 68 (1996); Sugarman, *supra* note 47, at 823; DeCarlo, *supra* note 47, at 271; Clotilde Fournier, *U.S.-France Treaty Tightens Limitation of Benefits, Adds Pension Provisions*, 5 J. INT'L TAX'N 488, 496 (1994); Michael J. Schinabeck, *The Limitation on Benefits Article of the U.S.-France Tax Treaty*, 25 TAX MGMT. INT'L J. 26 (1996).

[55] *See* Convention Between the United States of America and the Portuguese Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 6, 1994, U.S.-Port., art. 17, *reprinted in* 3 Tax Treaties (CCH) ¶ 7803.18; Convention Between the Government of Sweden and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 1, 1994, U.S.-Swed., art. 17, *reprinted in* 3 Tax Treaties (CCH) ¶ 8801.18. *See also* de Lignie, *supra* note 54, at 75-77 (for more information on these Treaties).

[56] The most recent invention is a clause in the new tax treaty between the United States and Switzerland, signed on October 2, 1996 but not yet ratified. Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, Oct. 2, 1996, U.S.-Switz., art. 22(1)(f), *reprinted in* 3 Tax Treaties (CCH) ¶ 9101.22 [hereinafter U.S.-Swiss Treaty]. Replacing the traditional ownership percentage or base erosion tests, this limitation on benefits clause is based on a "predominant interest" in the company seeking treaty benefits. Compared with prior clauses, differences in detail mainly concern the danger of base erosion and do not address the ownership problem. The clause appears to lack a clear definition of predominant interests. If the

velopment toward better limitation on benefit clauses appears in sight. At present, the United States seems unlikely to alter or redefine its unpredictable treaty policies concerning the treatment of European companies.[57] A detailed analysis of the U.S.-German clause reveals its nonconformity with European Union law and, therefore, provides a more persuasive and appropriate means to initiate changes in the U.S. treaty-making policy than would an analysis of recent clauses that show an attempt to reconcile the differing opinions.

Third, while other treaties are being renegotiated and equipped with better limitation on benefit clauses, the U.S.-German Treaty remains unchanged. To date, no renegotiation is in sight.[58] Judicial remedies are rather ineffective in initiating changes in the Treaty because they cannot directly attack the Treaty, only an individual taxpayer's tax assessment.[59] Furthermore, companies do not attempt to have certain corporate structures approved by the courts if they would potentially run afoul of the anti-treaty shopping law. Litigation over this issue might be too costly, risky, and time-consuming.[60] Instead of going to court, taxpayers seem either to alter the tax structure of their investments and choose safer locations, or they tolerate the tax treatment under the Treaty. In addition, Germany is not a low-tax jurisdiction, so treaty shopping is less attractive and less prominent than in low-tax or no-tax jurisdictions.[61] This fact, however, does not eliminate the possible deterrent effect of the U.S.-German Treaty on companies that wish to invest in Germany for reasons other than tax treatment.

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term is understood in the narrow sense of corporate law, the test will result in the same 50 % ownership requirement that the U.S.-German Treaty establishes. In light of European Union law, the new clause will not make a significant difference. See, for a recent discussion, Harrison J. Cohen et al., *Analysis of the New U.S.-Switzerland Income Tax Treaty*, 26 TAX MGMT. INT'L J. 47 (1997); Howard R. Hull, *Limitation on Benefits in the New US-Switzerland Treaty*, 51 BULL. INT'L FISCAL DOC. 2 (1997). The provision in the U.S.-Swiss Treaty, however, deviates from all U.S. Model Treaties, and its inclusion seems to be a singular event rather than a new direction in U.S. tax treaty policy. Moreover, Switzerland has not yet joined the European Union, so it is not bound by the obligations of the EC Treaty, as Germany and other EU Member States are.

[57] U.S. treaty policy has been criticized for its deterrent anti-treaty shopping clauses. A recent study argued that U.S. policy is made without considering the impact on competitiveness and the effects of stringent anti-treaty shopping provisions. *U.S. Tax Policy Made Without Considering Impact on Competitiveness, Study Says*, INT'L BUS. & FIN. DAILY (BNA) (Aug. 14, 1996), *available in* WESTLAW.

[58] *See* Fogarasi et al., *supra* note 31, at 141 (reporting that there is no income tax treaty under active negotiation between the United States and Germany).

[59] *See infra* text accompanying notes 254-60.

[60] At the time of this writing, no case is pending before the Court of Justice.

[61] However, treaty shopping in Germany can be attractive even from a narrow tax planning point of view. Due to particularities in the international tax treaty network, high-tax European countries can offer a preferential way to route investments from the United States to South America, Africa, or Asia. *See* Marshall J. Langer, *Outbound Treaty Shopping Offers Advantages for US Multinationals*, 17 INTERTAX 333 (1989).

Finally, the U.S.-German Treaty exemplifies the dilemma of whether it is preferable to regulate treaty shopping on a treaty level or on a national law level. Deficits in the limitation on benefits clause of this Treaty seem to impact the interplay between treaty law and German law and create reconciliation difficulties.[62] The possibility of treaty shopping has resulted in recent internal tax legislation in Germany. A new section, 50(d)(1a), was added to the German Income Tax Code by the Anti-Abuse and Tax Code Revision Act of 1993 in order to curtail treaty shopping.[63] This new section requires companies to meet one of two tests[64] in order to refute the presumption of treaty shopping[65] and thus be entitled to the benefits of a tax treaty. The enactment of this section is a legislative reaction to German case law that sanctioned conduit companies engaged in treaty shopping.[66]

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[62]In some fields of law, treaty shopping prevention is even stronger at a national law level than at treaty level. For example, national laws which require adherence to arm's-length principles of related-party transactions can have a strong deterrent effect on tax evasion. Similarly, stringent debt-equity rules can avoid the abuse of conduit entities for tax saving purposes.

[63]*See* Anti-Abuse and Tax Code Revision Act of Dec 21, 1993, Bundesgesetzblatt [Federal Law Gazette] [BGBl.] I 1993, at 2310. EStG, § 50(d)(1a) has been effective from the tax assessment period beginning on or after January 1, 1994. EStG, *supra* note 9, § 50(d)(1a). The section provides: "A foreign company is not entitled to tax relief (tax exemption or tax reduction according to § 44(d) or according to a convention for the avoidance of double taxation) to the extent that individuals hold an interest in it who could not claim such tax relief if they directly earned the income, and if there are no business or other considerable reasons for interposing such foreign company, and the company does not conduct a business of its own." *Id.*

[64]The tests are structured similar to common limitation on benefits provisions in treaties. A subjective test requires ownership by persons who are entitled to the treaty themselves, and an objective test is similar to business conduct tests found in treaties. The tests may be fulfilled alternatively. Contrary to Article 28 of the U.S.-German Treaty, however, the tests do not necessarily deny all benefits; instead, they may grant benefits in part. EStG, *supra* note 9, § 50(d)(1a).

[65]This presumption is based on general German tax law considerations. In principle, tax authorities face a duty to investigate the relevant facts of a case in the course of assessing tax debt. Abgabenordnung [General Tax Code] [AO] § 88(1). Once a tax return is filed with the authorities, they will launch any additional inquiry that is necessary to clarify the return. In these procedures, the taxpayer has to co-operate with the authorities and provide them thorough information in order to avoid an estimation of tax debt and an imposition of coercive payments against the taxpayer. AO §§ 90(1), 162, 328, 329. However, in cross-border cases the burden of producing evidence shifts completely to the taxpayer. AO § 90(2). In conjunction with EStG § 50(d)(1a), the taxpayer is required to discharge itself of the presumption of treaty shopping.

[66]Before the enactment of EStG 50(d)(1a), the Federal Tax Court applied AO § 42 to cases of treaty abuse. This section is a general anti-abuse provision and sets out in its first subsection: "The tax law cannot be circumvented by the abuse of formally admissible arrangements." *Id.* However, the courts decided that benefit from tax treaties is not abusive if the taxpayer is a third-country resident, and, therefore, does not directly affect German internal tax law. The Federal Tax Court, for example, sanctioned a conduit company owned by Monaco residents for that reason. Bundesfinanzhof [Federal Tax Court] [BFH], Decision of Oct. 29, 1981, Bundessteuerblatt [Federal Tax Bulletin] [BStBl.] II 1982, at 150. Reacting

In practice, however, section 50(d)(1a) may deviate from Germany's double tax treaties because its scope of application overlaps with Article 28 of the U.S.-German Treaty.[67] Although the legislative history of section 50(d)(1a) does not evidence an intention to override treaty obligations,[68] a conflict between national law and the Treaty is likely.[69] Against this background, a U.S.-German Treaty that clearly conflicts with European Union law provides a strong incentive to harmonize treaty and national anti-abuse law.[70]

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to the decisions of the Federal Tax Court, Article 28 of the U.S.-German Treaty has been increasingly invoked by the German tax authorities and finally led to the enactment of EstG § 50(d)(1a). EStG, *supra* note 9, § 50(d)(1a). *See* Lorence, *supra* note 66, at 126; Helmut Becker, *Treaty Shopping — a German Approach*, 1 J. STRATEGY IN INT'L TAX. 191, 194 (1985).

[67] Both laws may be applied in a typical treaty shopping situation. *See supra* Part I.A.

[68] In its hearings, the federal parliament expressed that EStG, *supra* note 9, § 50(d)(1a) had the same thrust as common anti-abuse provisions in tax treaties and reaffirmed the objectives of such provisions. Bundestagsdrucksache [Parliamentary Documents] [BT-Drucks.] 12/5630, Sept. 7, 1993, at 65. Even if this statement could be interpreted as a commitment to apply the provision only beyond the scope of treaty provisions, it would not bind tax authorities and tax courts. In addition, the application of the new section is unpredictable, and it has been criticized for its lack of clarity. *See* Wilhelm Haarmann & Barbara Busch, *New German Anti-Abuse Tax Legislation*, 22 INTERTAX 208, 209 (1994).

[69] As pointed out in a recent decision of the Federal Tax Court, German national law may deviate from tax treaty obligations and even suspend these obligations because treaties are subject to unilateral changes by German legislation. Bundesfinanzhof [Federal Tax Court] [BFH], Decision of July 13, 1994, Bundessteuerblatt [Federal Tax Bulletin] [BStBl.] II 1995, at 129; *see also* Hey, *supra* note 47, at 112; Helmut Becker & Felix Würm, *Double-taxation conventions and the Conflict between International Agreements and Subsequent Domestic Laws*, 16 INTERTAX 257, 259 (1988). Such legislative reaction, known as treaty override, is well-known and widely accepted in the United States. However, treaty override has been criticized because it clearly contravenes obligations under international law. *See, e.g.*, Stephan Eilers, *Override of Tax Treaties under the Domestic Legislation of the U.S. and Germany*, 19 TAX MGMT. INT'L J. 295 (1990); Richard L. Doernberg, *Overriding Tax Treaties: The U.S. Perspective*, 9 EMORY INT'L L. REV. 71 (1995); David Williams, *Freedom of Establishment and Double Taxation Agreements*, 19 EUR. LAW REV. 313, 318 (1994).

[70] In general, a harmonization of treaty law and national law concerning treaty shopping could be accomplished by making the application of national provisions expressly subsidiary to the existence of similar treaty provisions, or incorporating all anti-abuse law into treaties and having no national provisions at all. Since the first solution creates problems of defining the exact scope of application and the second solution is difficult to realize throughout the world's treaty network, a future U.S.-EU Treaty containing anti-abuse law would be the best way of harmonization. *See infra* Part III.C. *See also* David A. Ward, *Abuse of Tax Treaties*, 23 INTERTAX 176, 184 (1995) (arguing that anti-abuse provisions should generally be implemented in treaties because then the contracting states have expressly agreed that they can be applied by either side, and the contracting states have an exact view of the treaty's scope of application).

II. ARTICLE 28 OF THE U.S.-GERMAN TREATY IN LIGHT OF THE EC TREATY

A. The Application of European Union Law

1. Tax Law Harmonization in the European Union

Income tax legislation is largely left to each Member State of the European Union. The EC Treaty contains no express mandate for harmonization of income tax laws among the Member States.[71] The EC Treaty does, however, provide a general and basic competence for legal harmonization which can also be employed to harmonize the Member States' tax laws.[72] To date, harmonization of direct taxes has occurred only in the form of a few specific directives, each with very limited application.[73] Beyond these directives, direct taxation is completely governed by the tax laws of the Member States.[74]

However, the laws of the Member States must be consistent with the whole body of European Union law.[75] National tax law must not contravene any EC Treaty provision as developed and interpreted by the European

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[71] Harmonization of income taxes, as well as any other direct taxes, is not regulated by the EC Treaty. Indirect taxes, however, are to be harmonized on the basis of the EC Treaty. EC TREATY arts. 95-99. This has happened with the Value Added Tax (VAT) which now is, apart from different tax rates, based on the same system throughout the European Union.

[72] *See* EC TREATY art. 100. Article 100 allows harmonization of the laws of the Member States to the extent that this is required for the efficient functioning of the common market created by the EC Treaty. *See* EC TREATY art. 2.

[73] *See, e.g.*, Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable to parent companies and their subsidiaries in different Member States, 1990 O.J. (L 225) 6; Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanging shares concerning companies of different Member States, 1990 O.J. (L 225) 1; Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustments of transfers of profits between associated undertakings, 1990 O.J. (L 225) 10. A proposed directive on company and dividend taxation, more general in its application, has been unsuccessful. Commission Proposal for a Council Directive concerning the Harmonization of Company Taxation and of Withholding Taxes on Dividends, 1975 O.J. (C 253) 2. These legislative acts harmonize the tax laws of the Member States in certain areas. As directives, they do not create a genuine "European" tax law but oblige the Member States to implement the directive, i.e., modify their national law accordingly. *See* EC TREATY art. 189. Separate national tax laws still exist, but they have been assimilated in their contents by EU legislation.

[74] *See* Case C-279/93, Finanzamt Köln-Altstadt v. Roland Schumacker, 1995 E.C.R. I-225, 257, para. 21, [1996] 2 C.M.L.R. 401, 422, para. 21; Case 270/83, Commission v. France, 1986 E.C.R. 273, 306, para. 24, [1987] 1 C.M.L.R. 401, 422, para. 24; Case C-175/88, Klaus Biehl v. Administration des Contributions du Grand-Duché de Luxembourg, Opinion Darmon, 1990 E.C.R. I-1779, 1786, para. 10, [1990] 3 C.M.L.R. 143, 146-47, para. 10.

[75] *See* Case C-279/93, Finanzamt Köln-Altstadt v. Roland Schumacker, 1995 E.C.R. I-225, I-257, para. 21, [1996] 2 C.M.L.R. 450, 473, para. 21.

Court of Justice.[76] The Court recently reiterated that "the powers retained by the Member States must nevertheless be exercised consistently with Community law...".[77] This obligation is directly derived from the EC Treaty.[78]

2. *The Prohibition of Discrimination in the EC Treaty*

The EC Treaty seeks to abolish all discrimination against individuals of Member States on grounds of their nationality.[79] This goal is accomplished by a general anti-discrimination rule and by other specifically enumerated freedoms.[80] The specific freedoms in the EC Treaty include the free movement of goods, the free movement of workers, the freedom of establishment, the freedom to provide services, and the free movement of capital and payments.[81]

The general anti-discrimination rule, however, has little effect on the U.S.-German Tax Treaty because the rule's ambit is very narrow. It has in-

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[76] *See id.*

[77] *Id.*

[78] *See* EC TREATY art. 5. This Article generally demands that the Member States comply with all obligations set out in the Treaty.

[79] These anti-discrimination rights, however, are no longer confined to individuals of Member States of the European Union. As of January 1, 1994, the European Economic Area [hereinafter EEA], a joint market between the EU and the members of the European Free Trade Association, has been established. Convention Establishing the European Free Trade Association, Jan. 4, 1960, 370 U.N.T.S. 3 [hereinafter EFTA]. In this context, the basic freedoms of the EC Treaty have been extended by the EEA to the EFTA members. Three former EFTA members, Austria, Finland, and Sweden, became full EU members on January 1, 1995. Therefore, only Norway and Iceland enjoy the basic freedoms of the EC Treaty without being EU members, together with Liechtenstein which joined the EEA on May 1, 1995. In the context of this analysis, these countries are in the same situation as full EU members regarding the basic freedoms. However, any nationals from non-EU and non-EFTA countries, for example U.S. citizens, cannot claim rights under the EC Treaty. Article 8 of the EC Treaty limits the rights conferred by the EC Treaty to citizens of the European Union, i.e., nationals of any of the Member States. EC TREATY art. 8.

[80] *See* EC TREATY art. 6. This Article provides in its first paragraph that "within the scope of application of the Treaty, and without prejudice to any special provisions contained therein, any discrimination on the grounds of nationality shall be prohibited." *Id.*

[81] *See* EC TREATY arts. 9-37, 48-51, 52-58, 59-66, 73a-73h. These freedoms were expected to be implemented pursuant to a specific program, which provided for the abolition of all national restrictions on the freedoms. That abolition should have taken place during a so-called transitional period, but the goals of the program have not been fully achieved yet. However, all freedoms are directly applicable after the transitional period has elapsed, regardless of the extent of EU legislation or other abolishing measures in the field. Case 2/74, Reyners v. Belgian State, 1974 E.C.R. 631, 652, para. 30, [1974] 2 C.M.L.R. 305, 327, para. 30. The freedoms are "binding" on Member States in the sense that the States are not allowed to legislate contrary to European Union law that has been enacted; however, because States retain domestic legislative power, they are still able to legislate in areas on which European Union law has not spoken even though the domestic legislation may be contrary to EU objectives. Case C-279/93, Finanzamt Köln-Altstadt v. Roland Schumacker, 1995 E.C.R. I-225, I-257, para. 21, [1996] 2 C.M.L.R. 450, 473, para. 21.

dependent effect only insofar as the discrimination is not specifically prohibited by one of the enumerated freedoms.[82] As long as the contested discriminatory law does not contravene an explicitly stated freedom, the Court of Justice will not apply the general anti-discrimination rule.[83]

3. *The Effect of European Union Law on National Law as Influenced by International Treaties*

European Union law is applicable to, and binding on, the national law systems of EU Member States.[84] The principle of supremacy, which national courts must follow, ensures that European Union law takes precedence over conflicting national law.[85] European Union law also has direct effect and enjoys supremacy over national law as that national law is modified or influenced by outside treaties.[86] Even if only one party to an international treaty is a Member State, EU Member States are obligated to follow the EC Treaty.[87] A treaty may also affect the Member State's national law provisions that are directly affected by the Treaty terms.[88] In

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[82] *See* Case 305/87, Commission v. Greece, 1989 E.C.R. 1461, 1477, paras. 13-14, [1991] 1 C.M.L.R. 611, 622, paras. 13-14.

[83] *See id.*

[84] This is established by case law and was first stated in Case 26/62, Van Gend en Loos v. Nederlandse Administratie der Belastingen, 1963 E.C.R. 1, 13, [1963] C.M.L.R. 105, 130.

[85] *See* Case 106/77, Amministrazione delle Finanze dello Stato v. Simmenthal S.p.A. (II), 1978 E.C.R. 629, 643-44, paras. 17-23, [1978] 3 C.M.L.R. 263, 283-84, paras. 17-23; Case C-213/89, Regina v. Secretary of State for Transport *ex parte* Factortame Ltd. (I), 1990 E.C.R. I-2433, I-2473, para. 20, [1990] 3 C.M.L.R. 1, 29, para. 20.

[86] *See* Case 235/87, Annunziata Matteucci v. Communauté Française of Belgium, 1988 E.C.R. 5589, 5612, para. 22, [1989] 1 C.M.L.R. 357, 372, para. 22; *Simmenthal (II)*, 1978 E.C.R. at 643-44, paras. 17-23, [1978] 3 C.M.L.R. at 283-84, paras. 17-23; Case 270/83, Commission v. France, 1986 E.C.R. 273, 307, para. 26, [1987] 1 C.M.L.R. 401, 423, para. 26; *see also* Norbert Herzig & Norbert Dautzenberg, *Der EWG-Vertrag und die Doppelbesteuerungsabkommen*, 45 DER BETRIEB [DB] 2519, 2521 (1992); Birgit Bachmann, *Diskriminierungsverbote bei direkten Steuern im Regelungsbereich des EG-Vertrages*, 40 RECHT DER INTERNATIONALEN WIRTSCHAFT [RiW] 849, 858 (1994).

[87] *See* Case 235/87, Annunziata Matteucci, 1988 E.C.R. at 5612, para. 22, [1989] 1 C.M.L.R. at 372, para. 22. However, the relationship between outside treaties and European Union law is different for treaties concluded before the EC Treaty. As the EC Treaty provides, those existing treaties shall not be affected by the EC Treaty. EC TREATY art. 234. The purpose of Article 234 was to facilitate membership in the European Union rather than impeding it by the existence of treaties concluded before joining the European Union. But Article 234 was not designed to define the relationship between European Union law obligations and conflicting treaty obligations. Thus, the provision does not cover the reverse case, (i.e., conflicts between the EC Treaty and recent double tax treaties), and an argument *e contrario* would not be in accordance with the purpose of the provision. *See* van Unnik & Boudesteijn, *supra* note 54, at 106; Hinnekens, *supra* note 50, at 156 (arguing that the provision does not eliminate a Member State's obligation to amend its later concluded treaties).

[88] *But see* van Unnik & Boudesteijn, *supra* note 52, at 106 (questioning whether international treaties are directly affected by European Union law solely aiming at intra-EU situations).

concluding a treaty, a Member State subjects itself to treaty obligations and must follow these obligations in practice. In Germany, tax treaty obligations are incorporated into national law because German tax law mandates that double tax treaties shall have predominance over internal law.[89] Obligations at the international law level do not exempt a Member State from compliance with European Union law, even if national law can still deviate from these obligations in practice.[90] The EC Treaty itself states that Member States must fulfill their obligations under European Union law and must not follow any conflicting law, even if the Member States have otherwise bound themselves through treaties.[91] Also, a lack of, or delay in, legal harmonization throughout the EU in the field of direct taxation does not entitle Member States to suspend their obligations under the EC Treaty.[92]

B. Discrimination by Article 28 of the U.S.-German Treaty

1. Discrimination by the Ownership Percentage Test

a. The Requirements of the Ownership Percentage Test

The ownership percentage test sets up detailed requirements for a taxpayer to qualify for benefits under the U.S.-German Treaty.[93] One require-

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[89] *See* AO, *supra* note 65, § 2.

[90] *See* Case 270/83, Commission v. France, 1986 E.C.R. 273, 307, para. 26, [1987] 1 C.M.L.R. 401, 423, para. 26. *See also* Williams, *supra* note 69, at 315; H.J. Kamphuis & F.P.G. Pötgens, *Goodbye Mr Bachmann, Welcome Mr Wielockx*, 50 BUL. INT'L FISCAL DOC. 2, 5 (1996).

[91] *See* EC TREATY art. 5 (providing that "Member States shall take all appropriate measures, whether general or particular, to ensure fulfillment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community. They shall facilitate the achievement of the Community's tasks. They shall abstain from any measure which could jeopardize the attainment of the objectives of this Treaty.").

[92] *See* Case 270/83, Commission v. France, 1986 E.C.R. 273, 306, para. 24, [1987] 1 C.M.L.R. 401, 422, para. 24.

[93] U.S.-German Treaty, *supra* note 1, art. 28(1)(e), ¶ 3249.57 [hereinafter ownership percentage test]. Article 28 provides that:

> 1. A person that is a resident of a Contracting State and derives income from the other Contracting State shall be entitled, in that other Contracting State, to all the benefits of this Convention only if such person is: a) an individual; b) A Contracting State, or a political subdivision or local authority thereof; c) engaged in the active conduct of a trade or business in the first-mentioned Contracting State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business; d) a company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange; e) aa) a person, more than 50 percent of the beneficial interest in which (or in the case of a company, more than 50 percent of the number of shares of each class of whose shares) is owned, directly or indirectly, by persons entitled to benefits of this Convention under subparagraphs a),

ment is that a person must be a resident of one contracting state and derive income from the other contracting state. This requirement is fulfilled if a German company receives dividends from its U.S. subsidiary.[94] The term "person" as used in this context includes individuals as well as companies.[95]

The interest in such a company must be owned by a person who, in turn, must meet one of three requirements: the person must be a resident of the United States or Germany, a citizen of the United States, or be a company whose shares are traded on a stock exchange in either of the contracting states.[96] In other words, each intermediate owner must also be entitled to Treaty benefits. Thus, the ultimate owner is always supposed to be an individual or a company connected to the contracting states. Under the ownership percentage test, nationals from states other than the United States or Germany cannot meet this requirement and cannot qualify for the Treaty.[97]

The ownership percentage test requires the ownership, by such persons, of more than a fifty percent beneficial interest in a company.[98] The

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b), d), or f) or who are citizens of the United States; and bb) a person, more than 50 percent of the gross income of which is not used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons not entitled to benefits of this Convention under subparagraphs a), b), d), or f) or who are not citizens of the United States; or f) a not-for-profit organization that, by virtue of that status, is generally exempt form income taxation in its Contracting State of residence, provided that more than half of the beneficiaries, members, or participants, if any, in such organization are persons that are entitled, under this Article, to the benefits of this Convention.

2. A person that is not entitled to the benefits of this Convention pursuant to the provisions of paragraph 1 may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income in question arises so determines.

3. For the purpose of paragraph 1, the term "recognized stock exchange" means: a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934; b) any German stock exchange on which registered dealings in shares take place; c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

4. The competent authorities of the Contracting States shall consult together with a view to developing a commonly agreed application of the provisions of this Article. The competent authorities shall, in accordance with the provisions of Article 26 (Exchange of Information and Administrative Assistance), exchange such information as is necessary for carrying out the provisions of this Article and safeguarding, in cases envisioned therein, the application of their domestic law.

Id.

[94] *See id.*

[95] *See* U.S.-German Treaty, *supra* note 1, art. 3(1)(d), ¶ 3249.07.

[96] *See* U.S.-German Treaty, *supra* note 1, art. 28(1)(e), ¶ 3249.57.

[97] *See id.*

[98] *See id.*

interest is beneficial if it is held by the person to whom the interest is attributable for tax purposes.[99] Ownership of shares is attributed to the shareholder for tax purposes.[100] The ownership percentage test mentions both direct and indirect ownership and thus covers multi-tier structures.[101] If a foreign company, incorporated in a third country, creates several fully-owned dependent corporations each of which is held by a German or U.S. majority, foreign nationals still own more than fifty percent indirectly, and the company is disqualified.

A second test set up in Article 28(1)(e)(bb) is conjunctive and must be fulfilled together with the ownership percentage test.[102] This "base erosion" test requires that no more than fifty percent of the taxpayer's gross income be used to meet liabilities of persons not entitled to Treaty benefits.[103]

b. The Activities Affected by the Ownership Percentage Test

The ownership percentage test impairs a non-German EU firm's business decisions in various situations. First, the firm can be affected when it initially sets up or buys a new company in Germany that does not meet the ownership percentage qualification. Second, a firm's business strategy is impeded if an existing company is to be restructured, for example in a merger, and will no longer qualify after the restructuring because it has lost its predominant German ownership.[104] The same result could happen if previously widespread ownership interests in a firm became concentrated in

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[99]This is analogous to what the Protocol to the Treaty provides for purposes of Article 10, namely that the source country will deem an income recipient resident in the other country to be the beneficial owner if the recipient is the person to whom the income is attributable for tax purposes under the laws of the source country. Protocol, *supra* note 1. The term "beneficial" is relevant in characterizing hybrid entities for treaty purposes. In the context of a stock corporation, it is not of importance. For the meaning of the term in tax treaties, see generally Cohen, *supra* note 54, at 405; Michael Cooper, *Interpretation of "Beneficial Owner" under U.S. Tax Treaties*, 13 TAX NOTES INT'L 1319 (1996); Jürgen Killius, *The Concept of "Beneficial Ownership" of Items of Income under German Tax Treaties*, 17 INTERTAX 340 (1989).

[100]This conclusion also follows from the German General Tax Code. *See* AO, *supra* note 65, § 39(1).

[101]*See* U.S.-German Treaty, *supra* note 1, art. 28(1)(e), ¶ 3249.57.

[102]*See id.*

[103]*See id.* This test avoids treaty shopping by obligees and equity holders. For example, if third country nationals arrange for nationals of the contracting states to own 100% of the corporation, they may try to capitalize the corporation by making loans. This is a mere corporate shell and does not meet the base erosion test. Meeting only the base erosion test is not sufficient. The ownership percentage test must be fulfilled in any case.

[104]The process to regain predominant ownership can only be initiated by owners of the company or third persons, not by the company itself. In contrast to reacquisition of shares by a corporation under U.S. law, German companies are usually not allowed to repurchase their own shares, unless they can prove one of the narrowly specified reasons for doing so. Aktiengesetz [Stock Corporation Act] [AktG] §§ 70-71e; Gesetz betreffend die Gesellschaften mit beschränkter Haftung [Close Corporation Act] [GmbHG] § 33.

one, or a few foreign hands.[105] A company set up in Germany and qualified for Treaty benefits cannot easily be sold, or can be sold only at a potentially lower value with existing majority-German ownership, because purchasers from abroad risk losing these benefits, resulting in a lower value for the company.

c. The Freedom of Establishment under the EC Treaty

(1) The Rule of Article 52 with Respect to Nationality Percentages

The freedom of establishment guaranteed in Article 52 of the EC Treaty is relevant to treaty shopping situations.[106] Article 52 guarantees nationals of any EU Member State the freedom "to take up and pursue activities," including setting up and managing companies, in any Member State under the same conditions as those which apply to the second Member State's nationals.[107] Simply stated, Article 52 requires every Member State to treat nationals of other Member States the same as it treats its own nationals.

Article 58 of the EC Treaty extends the rights in Article 52 to any form of business association or legal entity formed under the law of a Member State and which has its registered office, administration, or place of business within the European Union.[108] Individuals as well as companies enjoy

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[105] This might be different if, in the case of a corporation, ownership is represented by shares in the corporation, and these shares are substantially and regularly traded on a stock exchange. Then, the corporation might pass the stock exchange test of Article 28(1)(d) of the U.S.-German Treaty. U.S.-German Treaty, *supra* note 1, art. 28(1)(d), ¶ 3249.57. This, however, cannot eliminate discriminatory effects of any of the other tests. *See infra* Part II.C.4.b.

[106] *See* EC TREATY art. 52. Article 52 provides:

> within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be abolished by progressive stages in the course of the transitional period. Such progressive abolition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any other Member State. Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 58, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital.

Id.

[107] *See id.*

[108] *See* EC TREATY art. 58 (providing that "companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States. 'Companies or firms' means companies or firms constituted under civil or commercial law, including co-

the freedom of establishment.[109] Therefore, it makes no difference whether the EU entities that own a German company are individuals or companies themselves. In the context of discrimination based on nationality, the "nationality" of a company is its registered office.[110] Under Article 58, in conjunction with Article 52, companies from EU countries must be treated by other EU countries as domestic companies.

Article 221 of the EC Treaty concerns the freedom of establishment with respect to shareholders' investment of capital in a company.[111] Even if nationals of other Member States do not intend to establish themselves in the concerned country but merely intend to hold shares of a company in that country, they shall be treated equally with respect to their participation in the capital of such a company.[112] Thus, a European company that operates an independent subsidiary in Germany is covered by Article 52 via Article 221 because the European company holds the subsidiary by owning its shares.[113]

The ownership percentage test is disadvantageous to nationals of other EU Member States and violates the guaranteed freedoms of Article 52. It is possible under the U.S.-German Treaty to establish a foreign-owned company in Germany, because the test does not prohibit the establishment of a business. Every EU national is free either to own a German corporation completely or to share ownership with German nationals. Yet, non-German EU nationals who establish a company in Germany do so under conditions less favorable than those faced by German-owned companies; such a company is not entitled to the benefits of the Treaty unless it limits its ownership by non-German EU nationals to a minority share. As a German-owned corporation need not do this, non-German EU nationals are not treated equally to German nationals.[114] Thus, a foreign-owned company[115] cannot

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operative societies, and other legal persons governed by public or private law, save for those which are 'non-profitmaking'.").

[109] *See id.*

[110] *See* Case 270/83, Commission v. France, 1986 E.C.R. 273, 304, para. 18, [1987] 1 C.M.L.R. 401, 420, para. 18. This view about the "nationality" of a company is mainly based upon the civil law concept that a company's principal place of business must be at the same place where the company is registered in order to grant a company corporate status in the state of registration. *See supra* note 43.

[111] *See* EC TREATY art. 221 (providing that "within three years of the entry into force of this Treaty, Member States shall accord nationals of the other Member States the same treatment as their own nationals as regards participation in the capital of companies or firms within the meaning of Article 58, without prejudice to the application of the other provisions of this Treaty").

[112] *See id.*

[113] In contrast, a branch or office of this company would be directly covered by Article 52 in conjunction with Article 58 of the EC Treaty.

[114] In the context of European Union law, it is irrelevant that these non-nationals are also not treated equally to U.S. nationals because this concern is beyond the application of the freedoms guaranteed in the EC Treaty.

[115] "Foreign owned" in this comment refers to ownership by non-German EU nationals.

freely choose its ownership structure. The Court of Justice pointed out in *Commission v. France* that a company faces discrimination if it cannot choose the legal nature of a secondary establishment without losing the benefit of a tax credit which is substantially the same as losing treaty benefits.[116] The same is true if a company cannot choose its ownership structure without losing tax treaty benefits.

Discrimination affects both partly and fully foreign-owned companies. While discriminatory effects upon a purely foreign-owned company seem clear, they are less obvious in the case of mixed ownership because German owners of the company are subject to the same tax disincentives as non-German owners. Therefore, tax authorities may argue that there is no specific discrimination against non-German EU nationals in denying the company the preferential tax treatment because German minority shareholders also suffer from that denial.

This argument, however, is irrelevant under European Union law. Whether the disqualified company is fully-owned by non-German EU nationals or partially owned by Germans cannot be the decisive factor for the question of discrimination because, under Article 52, in conjunction with Article 58, the choice of the ownership structure of an establishment is protected.[117]

More importantly, the entire company, and not just a single shareholder, must qualify for the Treaty. As far as the company is concerned, the German minority owners who disqualify the company are not directly addressed by the ownership percentage test.[118] Even if the ownership percentage test differentiates between the shareholders' nationalities, those shareholders are only indirectly affected on an economic level because their company is less profitable due to a higher tax debt.

Moreover, the ownership percentage test is based not on nationality per se, but on a nationality percentage. However, the Court of Justice has already held that such nationality percentage requirements are discriminatory. In *Agegate*,[119] U.K. law provided that, in order to obtain fishing registration

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[116]Case 270/83, Commission v. France, 1986 E.C.R. 273, 305, para. 22, [1987] 1 C.M.L.R. 401, 422, para. 22.

[117]*See id.*

[118]Therefore, the German shareholders are not in a situation of reverse discrimination (*discrimination à rebours*). Reverse discrimination means that, as a purely internal matter, nationals are treated worse than non-nationals, which, however, is not prohibited by the EC Treaty because it is outside the EC Treaty's scope of application. Case 175/78, Regina v. Saunders, 1979 E.C.R. 1129, 1135, paras. 11-12, [1979] 2 C.M.L.R. 216, 227, paras. 11-12; Case 204/87, Bekaert v. Procureur de la Republique, 1988 E.C.R. 2029, 2039, para. 12, [1988] 2 C.M.L.R. 655, 660, para. 12; Joined Cases C-29-35/94, Ministere Public v. Aubertin & Others, 1995 E.C.R. I-301, I-316, para. 9, [1996] 2 C.M.L.R. 1, 11, para. 9.

[119]Case C-3/87, Regina v. Ministry of Agriculture, Fisheries and Food *ex parte* Agegate Ltd., 1989 E.C.R. 4459, [1990] 1 C.M.L.R. 366. *See also* Case C-216/87, Regina v. Ministry of Agriculture, Fisheries and Food *ex parte* Jaderow Ltd., 1989 E.C.R. 4509, [1991] 2 C.M.L.R. 556.

and licenses in the United Kingdom, at least seventy-five percent of the crew members of British fishing vessels must have British nationality or that of another country of the Community. The Court held that Community law does not preclude a Member State from stating such a requirement.[120] But the Court also ruled that a Member State is not allowed to require that a percentage of the crew of the vessels must reside ashore in the concerned Member State.[121]

Later in *Factortame*,[122] the issue was also U.K. legislation providing that a fishing vessel must, in order to be eligible for registration, be at least seventy-five percent British-owned, managed from the United Kingdom, and that the charterers, managers, or operators must be British nationals resident and domiciled in the United Kingdom, or British companies owned by at least seventy-five percent British nationals. The Court held that all these conditions, except the requirement to be managed from the United Kingdom, were contrary to Article 52 of the EC Treaty, regardless of their actual discriminatory extent.[123]

Despite factual differences, the rule from these cases applies to the ownership percentage test although the rule was derived from a different legal context. The cases differ from the ownership percentage test in their results regarding the nationality requirements. While in both cases the nationality percentage was an essential requirement to attain registration and operate a business at all, the percentage required in the ownership percentage test is only a standard for granting or denying a preferential treatment and does not forbid a company's establishment per se. The *Agegate* decision also differs from the ownership percentage test insofar as the employees' nationality was decisive.[124] But this aspect was overruled in *Factortame* where the concept of corporate ownership, similar to that in the ownership percentage test, was at issue.[125] The nationality requirement in *Factortame* also covered the management structure and the place from where the company is managed, and was therefore more far-reaching than the ownership percentage test.[126]

The ownership percentage test is analogous to the main point in both these cases, i.e., that a nationality percentage is not a valid criterion for differential treatment. The reason is that percentage requirements do not take into account individual differences, based on nationality, that could make a

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[120] *See Agegate*, 1989 E.C.R. at 4502, para. 21, [1990] 1 C.M.L.R. at 395, para. 21.

[121] *See id.*, 1989 E.C.R. at 4502-03, paras. 22-26, [1990] 1 C.M.L.R. at 395-396, paras. 22-26.

[122] Case C-221/89, Regina v. Secretary of State for Transport *ex parte* Factortame Ltd. (II), 1991 E.C.R. I-3905, [1991] 3 C.M.L.R. 589.

[123] *See Factortame (II)*, 1991 E.C.R. at I-3967, para. 33, [1991] 3 C.M.L.R. at 628, para. 33.

[124] *Agegate*, 1989 E.C.R. 4459, [1990] 1 C.M.L.R. 366.

[125] *Factortame (II)*, 1991 E.C.R. I-3905, [1991] 3 C.M.L.R. 589.

[126] *See id.*

measure less discriminatory. The percentage requirements in the cases as well as in the ownership percentage test are unconditional and do not provide for any exceptions or alternatives. They are stripped down to pure nationality-based preferences which are contrary to the core freedoms of the EC Treaty.

It is irrelevant that the actual discrimination in *Factortame* was greater than discrimination under the ownership percentage test. This difference stems from the fact that the Member States, based on EC directives, have the power, and are even encouraged, to limit the capacity of their fishing fleets.[127] In contrast, Member States who seek to abolish treaty shopping cannot rely on that basis because, as European Union law presently stands, a Member State's interest in treaty shopping protection is not specifically safeguarded by European Union law. Thus, discriminatory effects were stronger in the cases concerning fishing vessels than they typically are in a treaty shopping prevention clause situation, because restrictive measures were, to some extent, legally authorized by EU legislation. Moreover, less favorable treatment is sufficient to affect a company's economic freedom and influence its decision of where to establish.[128] Although establishment of a company need not be totally impossible, the company faces discriminatory effects under EU legislation. Therefore, the result in *Factortame* was independent of the details of the particular discriminatory measures and applies to the discriminatory ownership percentage test.

Finally, the economic background of the *Agegate* and *Factortame* cases is similar to the problem of treaty shopping. In both cases, the national law that was found to be discriminatory intended to make "quota-hopping" less attractive, i.e., it sought to prevent fishing vessels from registering in a Member State of their choice to exploit this Member State's fishing quotas.[129] This discriminatory law is similar to treaty shopping provisions because both are based on the idea of limiting preferences, and neither takes into account possible benefits from the action it seeks to prevent.[130] If the discriminatory ownership percentage test or any similar test in other tax treaties were to be examined by the Court of Justice, the Court might not only regard it as discriminatory for reasons laid out earlier but might specifically base its finding on its established case law on fishing quotas.

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[127] *See Agegate*, 1989 E.C.R. 4459, 4500, para. 17, [1990] 1 C.M.L.R. 366, 394, para. 17; *Factortame (II)*, 1991 E.C.R. at I-3963-64, para. 17 [1991] 3 C.M.L.R. at 625-26, para. 17.

[128] *See* Case C-19/92, Kraus v. Land Baden-Württemberg, 1993 E.C.R. I-1663, I-1697, para. 32.

[129] *See Agegate*, 1989 E.C.R. 4459, [1990] 1 C.M.L.R. 366; *Factortame (II)*, 1991 E.C.R. I-3905, [1991] 3 C.M.L.R. 589.

[130] Interestingly, the prevention of quota hopping is, from a public policy standpoint, criticized for almost the same reasons as treaty shopping prevention. *See* R. R. Churchill, *Quota Hopping: The Common Fisheries Policy Wrongfooted*, 27 COMMON MKT. L. REV. 209, 243-47 (1990).

(2) The Lack of a De Minimis Rule

No de minimis rule can eliminate the discriminatory character of the ownership percentage test. A de minimis argument evaluates the overall tax burden on a disqualified company and asserts that this burden would not considerably increase if no benefits are granted. Without the U.S.-German Treaty benefits, however, the tax rate would be six times higher than the rate available under the Treaty.[131] This discriminatory difference cannot be regarded as de minimis.

Assuming the U.S.-German Treaty contains smaller tax rate differences after a future renegotiation, or that other treaties between the United States and individual Member States of the EU lead to smaller and negligible differences in a situation comparable to the one under this Treaty, the Court of Justice would still not apply a de minimis rule. The Court generally rejects de minimis rules. In particular, the Court rejected such a rule in either the *Agegate* and *Factortame* cases which dealt with discriminatory measures comparable to the ownership percentage tests.[132] In cases dealing with Articles 30 and 36 of the EC Treaty, which provide for the free movement of goods,[133] the Court expressly stated that these provisions are not subject to a de minimis exception. For example, in *Commission v. Greece,* the Court held there is no requirement that restrictive effects on the free movement of goods actually arise.[134] Later, in *Commission v. United Kingdom,* the Court pronounced that even if restrictive rules were of minor importance in practice, no de minimis principle could save them from the application of Articles 30 and 36.[135] It can be argued that the prohibition in Article 30 already implies a serious and more than negligible obstacle to trade between Member States. More importantly, in *Leclerc-Siplec,* it was argued that the introduction of a de minimis test might induce national courts, which have primary responsibility for applying Article 30, to exclude too many restrictive measures from the scope of the prohibition laid down by that Article.[136] These same arguments also apply to the freedom of establishment. In *Kraus*, the Court developed the general formula that measures "liable to hinder or make less attractive the exercise of the basic

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[131] *See supra* notes 8, 11 and accompanying text.

[132] *See Ex parte* Agegate, 1989 E.C.R. 4459, [1990] 1 C.M.L.R. 366; Case C-221/89, Regina v. Secretary of State for Transport *ex parte* Factortame Ltd. (II), 1991 E.C.R. I-3905, [1991] 3 C.M.L.R. 589.

[133] *See* EC TREATY arts. 30, 36.

[134] Case 124/85, Commission v. Hellenic Republic, 1986 E.C.R. 3935, 3948, para. 7, [1988] 2 C.M.L.R. 518, 526, para. 7.

[135] Case C-30/90, Commission v. United Kingdom, 1992 E.C.R. I-829, I-864, 866, para. 15, 25 [1992] 2 C.M.L.R. 709, 758-60, para. 15, 25.

[136] *See* Case C-412/93, Leclerc-Siplec v. TF1 Publicité and M6 Publicité, Opinion Jacobs, 1995 E.C.R. I-179, I-195-96, para. 42, [1995] 3 C.M.L.R. 422, 439, para. 42.

freedoms" are discriminatory.[137] Therefore, the threshold for measures to be discriminatory is very low, and allowing a de minimis exception to the freedom of establishment would undermine this freedom. Accordingly, the Court held in *Commission v. France* that "Article 52 prohibits all discrimination, even if only of a limited nature."[138]

(3) Interpretation of "Residence" in the Contracting States

Discrimination under the U.S.-German Treaty occurs because companies must be owned by persons entitled to the benefits, i.e., residents of the United States and Germany.[139] A broad interpretation of "residence" that would also cover residents of EU Member States would resolve the conflict with European Union law. That interpretation, however, is only possible under European Union law and not under national law.

European Union law allows a broad construction of legal terms. This well-established principle of interpretation of European Union law is a specific teleological approach that is intended to accomplish the objectives of the EC Treaty to the largest possible extent (*effet utile*).[140] Instead of employing a literal or strict interpretation, provisions of the EC Treaty may be construed according to the general objectives set out in the preamble and Articles 2 and 3 of the EC Treaty.[141] Each provision is interpreted not on its own but in the larger context of European Union law.[142] The most liberal interpretation that effectuates the objectives of European Union law is preferred.[143] In this context, an application of the *effet utile* principle would lead to a broad construction of "residence" in the sense that it would cover not only German and U.S. nationals but all nationals of the Member States of the European Union. This construction would solve the problem of discrimination against EU nationals by treating them equally, and, therefore, would effectuate the freedom of establishment.

Yet, interpretation principles under national law lead to different results. An interpretation that contravenes the clear wording of a treaty is not legitimate. Under most national laws, interpretation focuses first on the natural meaning or usage of the words.[144] Even if the meaning or usage is

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[137] Case C-19/92, Kraus v. Land Baden-Württemberg, 1993 E.C.R. I-1663, I-1697, para. 32.

[138] Case 270/83, Commission v. France, 1986 E.C.R. 273, 305, para. 21, [1987] 1 C.M.L.R. 401, 421, para. 21.

[139] *See* U.S.-German Treaty, *supra* note 1, art. 28(1)(e), ¶ 3249.57.

[140] *See, e.g.*, Case 187/87, Saarland v. Minister for Industry, 1988 E.C.R. 5013, 5042, para. 19, [1989] 1 C.M.L.R. 529, 542, para. 19.

[141] *See* Case 29/69, Stauder v. City of Ulm, 1969 E.C.R. 419, 425, para. 4, [1970] C.M.L.R. 112, 118, para. 4.

[142] *See* Case 283/81, C.I.L.F.I.T. Srl v. Ministry of Health, 1982 E.C.R. 3415, 3430, para. 20, [1983] 1 C.M.L.R. 472, 491, para. 20.

[143] *See Stauder*, 1969 E.C.R. at 425, para. 4, [1970] C.M.L.R. at 118, para. 4.

[144] *See, e.g.*, Moskal v. United States, 498 U.S. 103, 108 (1990).

unambiguous, construction can take into account the objective and purpose of the provision and, therefore, can deviate from its words to a certain extent. However, these general and unilateral principles do not apply to the interpretation of tax treaties.[145] The German Federal Tax Court has pointed out that the principle of state sovereignty calls for a restrictive application of interpretation principles in the context of international conventions.[146] A treaty cannot be interpreted in contravention of its explicit and unambiguous wording, and tax authorities have to abide by this wording.[147] As a result, there is no authority for a broader interpretation of the term "residence" covering EU nationals in general, because this term is clearly defined in the U.S.-German Treaty.

German tax authorities thus face a conflict between the two different standards for interpretation. They cannot follow their interpretation obligations under European Union law and at the same time comply with a different interpretation standard for treaties as prescribed by the German courts.[148] A practical argument against a treaty application that goes beyond the treaty wording is that such a reading would lead to bilateral conflicts on a political level.[149] A unilateral broad interpretation of a treaty by a European country would damage that country's international reputation, undermine the U.S. treaty policy, and ultimately provoke the United States and other treaty partners to terminate existing treaties. Although these terminations would open the doors to renegotiation and perhaps reconciliation with European Union law, it would also lead to an unpredictable tax situation between the United States and European countries. Even if the U.S.-German Treaty continued to exist after a unilateral breach, economic consequences would follow.[150] It is likely that the tax authorities will comply with the traditional treaty interpretation methods and will not apply the U.S.-German Treaty against its clear wording.[151] Although there is no formal system of binding precedents in Germany, German tax authorities usually follow the Federal Tax Court's decisions. The tax authorities also lack the ability to directly invoke a ruling by the Court of Justice on this matter. The issue must be dealt with, if at all, before national courts and only later

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[145] *See, e.g.*, Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4 INT'L TAX & BUS. LAW. 1, 29-33 (1986) (comparing tax treaty interpretation principles with the interpretation of domestic statutes).

[146] *See* Bundesfinanzhof [Federal Tax Court] [BFH], Decision of Sept. 13, 1972, Bundessteuerblatt [Federal Tax Bulletin] [BStBl.] II 1973, at 57.

[147] *See id.*

[148] *See id.*

[149] *See* Becker & Würm, *supra* note 69, at 262-63 (pointing out the political consequences of a breach of a double taxation agreement).

[150] *See id.* at 262.

[151] *See also* Norbert Dautzenberg, *Die Wegzugssteuer des § 6 AStG im Lichte des EG-Rechts*, 52 BETRIEBS-BERATER 180, 184 (1997) (discussing the tax authorities' possible reactions to rules incompatible with European Union law).

before the Court of Justice.[152] In sum, it is unlikely that German tax authorities will grant benefits based on a broad construction of the U.S.-German Treaty.

d. The Freedom of Capital Movement under the EC Treaty

The ownership percentage test also causes discrimination against free movement of capital. Article 73b of the EC Treaty guarantees the free movement of capital and payments.[153] To the extent that establishing, operating, buying, selling, or merging a company requires the investment of capital, the free movement of capital is affected by the ownership percentage test. If non-nationals, individuals as well as companies, buy shares in a German company, they could disqualify this company from receiving Treaty benefits, and, accordingly, they would suffer tax disadvantages. Thus, their investment may be discriminated against compared to the investment of Treaty nationals. This treatment amounts to discrimination against non-nationals based on the situs of their capital investment.

Yet, Article 73b of the EC Treaty has no independent meaning in this situation because Article 52, the freedom of establishment clause, is primarily relevant. Both discrimination against the freedom of establishment and the free movement of capital occurs in this case. The Court held in *Bachmann*[154] that Article 73b does not prohibit restrictions that result indirectly from restrictions on other basic freedoms. For a company disqualified from the Treaty, not only the flow of capital as such is obstructed, but also the purpose of the investment itself and the tax considerations on the company level.

2. The Role of Discretionary Relief under Article 28

Companies that do not fall within the scope of Article 28(1) of the Treaty may instead receive preferential tax treatment on the basis of a discretionary decision under Article 28(2).[155] But even if the company commences proceedings for discretionary relief under the Treaty, the discrimination continues because these proceedings do not guaranty auto-

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[152] *See infra* text accompanying notes 254-59.

[153] *See* EC TREATY art. 73b. Article 73b provides as follows:

> 1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited. 2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited.

Id.

[154] Case C-204/90, Bachmann v. Belgian State, 1992 E.C.R. I-249, I-285, para. 34, [1993] 1 C.M.L.R. 785, 810, para. 34. The case dealt with Article 67 of the EC Treaty, the former provision on the freedom of capital, which was replaced by Article 73b with effect from January 1, 1994. EC TREATY art. 73b.

[155] *See supra* note 93 for the text of Article 28(2).

matic qualification.[156] The authorities of the State in which the income arises are allowed to grant Treaty benefits even if the tests of Article 28(1) are not satisfied. For a German company receiving dividends from the United States, the competent authority is the Secretary of the Treasury or his delegate.[157]

The criteria for a discretionary decision are laid out in a Memorandum supplementing the U.S.-German Treaty.[158] A German corporation that has been denied Treaty benefits due to a predominance of foreign shareholders may be eligible for discretionary relief on the basis of this Memorandum. The Memorandum states how the competent authority should exercise its discretion. The authority is supposed to take into account "all relevant facts and circumstances."[159] The Memorandum commits the authority to considering the objectives of the European Union[160] and the views of the tax authorities of its Member States.[161]

Since this part of the Memorandum refers to the problem of EU ownership interests in companies, discretionary relief will probably be granted to a German company discriminated against because of predominantly non-German EU shareholders. However, the decision to grant relief is discretionary because it is the authority that decides whether to grant benefits at all and to what extent,[162] not the Treaty provision itself. There is no specified legal claim or entitlement for discretionary relief under Article 28(2). As the wording of the Treaty unmistakably indicates, entities qualifying under Article 28(1) "shall be entitled" to benefits; whereas under Article

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[156] *See* Helmut Becker & Otmar Thömmes, *Treaty Shopping und EG-Recht—Kritische Anmerkungen zu Art. 28 des neuen deutsch-amerikanischen Doppelbesteuerungsabkommens*, 44 DER BETRIEB 566, 567 (1991); Stephan Eilers & Maureen Watkins Brügmann, *Article 28 of the German-US Double Taxation Treaty of 1989: An appropriate Solution to the Treaty Shopping Problem*?, 20 TAX PLANNING INT'L REV. 15, 21 (1993).

[157] *See* U.S.-German Treaty, *supra* note 1, art. 3(1)(i)(aa), ¶ 3249.07.

[158] *See* Understandings Regarding the Scope of the Limitation on Benefits Article in the Convention Between the Federal Republic of Germany and the United States of America, Aug. 29, 1989, reproduced in Technical Explanation, *supra* note 1 [hereinafter Memorandum].

[159] *See id.*

[160] The Memorandum provides that "the discretionary authority granted to the competent authorities in paragraph 2 is particularly important in view of, and should be exercised with particular cognizance of, the developments in, and objectives of, international economic integration, such as that between the member countries of the European Communities and between the United States and Canada." *Id.*

[161] The Memorandum provides that "the competent authorities will consult further on these issues, and may also take into account the views of the tax authorities of other States, including, in particular, Member States of the European Communities." *Id.*

[162] The Memorandum does not mention whether discretionary relief always equals a full Treaty qualification under Article 28(1). Therefore, it is possible that benefits are not granted to the full extent, so that the company ends up with a tax rate between the regular rate and the preferential Treaty rate.

28(2), benefits may be granted to persons "not entitled."[163] Also, the competent authorities are not compelled to consider the factors mentioned in the Memorandum. The Memorandum is merely a separate document and not part of the Treaty because no reference to it is made in the Treaty. The purpose of the Memorandum is to further explain the more detailed Treaty provisions, not to modify them.[164] The authority cannot be forced to decide in favor of a discriminatorily treated taxpayer. Therefore, the considerations in the Memorandum are not sufficient by themselves to qualify under Article 28.[165] Even if the Memorandum were part of the Treaty and legally binding, it would only give general guidance to an authority rather than clear-cut factors to be taken into account by the authority in exercising its discretion. This scenario holds true despite optimism about the Treaty Memorandum at the time of the conclusion of the Treaty. The negotiators of the Treaty expected a considerable number of cases to be preferably decided under the discretionary relief procedure in order not to discourage investors by the tests of Article 28(1), and they also stated their intention to review the boundary line between Articles 28(1) and 28(2) at a later stage.[166] To date, however, this review has not occurred, and this mere intention does not create legal rights.

Apart from these uncertainties in the results, the procedure to obtain discretionary relief also creates practical disadvantages in terms of time and costs. Reliable and predictable results in the assessment of tax debt may only be expected from a qualification for Treaty benefits under Article 28(1), not from a discretionary decision. An application for qualification under Article 28(2) is more costly and time-consuming than a qualification *qua lege*.[167] Regardless of its results, the procedure for discretionary relief puts a company at a formal disadvantage. A revenue procedure by the U.S. Department of the Treasury deals with the procedural details of requesting

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[163] U.S.-German Treaty, *supra* note 1, art. 28, ¶ 3249.57.

[164] The Memorandum is designed to give guidance to taxpayers and tax authorities, and to allow the competent authorities to develop "further understandings and interpretations." Memorandum, *supra* note 158.

[165] *See* Becker & Thömmes, *supra* note 156, at 567; Debatin, *supra* note 46, at 661. *See also* van Herksen, *supra* note 40, at 26 (making the same argument for a similar clause in the U.S.-Dutch Treaty).

[166] *See* Memorandum, *supra* note 158. *See also* Mimi E. Gild, Note, *Tax Treaty Shopping: Changes in the U.S. Approach to Limitation on Benefits Provisions in Developing Country Treaties*, 30 VA. J. INT'L L. 553, 594 (1990); Jonathan Kim, *The U.S.-West German Income Tax Treaty: Can Article 28's Limitation on Benefits Serve as a Model for the Treasury's Anti-Treaty Shopping Policy?*, 43 TAX LAW. 983, 1000 (1990).

[167] The qualification is achieved *qua lege* because it does not require an advance competent authority ruling or approval but is self-executing, as the Memorandum to the Treaty points out regarding Article 28(1)(c). *See* Memorandum, *supra* note 158. Therefore, a company's qualification under Article 28(1) will automatically be considered in the notice of tax assessment. Conversely, a qualification for Treaty benefits based upon discretionary relief will take time while the competent authority decides whether to grant such a qualification.

discretionary relief when the competent authority is the U.S. Treasury.[168] The revenue procedure provides that no advance determination by the authority is permitted and no positive ruling on qualification for Treaty benefits will be provided; only rulings on non-qualification will be given.[169] Therefore, the taxpayer has no opportunity to thoroughly plan the tax situation based on the authority's determination. If the corporate structure has already been established, no verification by the authority takes place until the tax is assessed. Thus, the tax has already been paid and must be refunded after relief is granted. This refund results in a financial disadvantage in terms of the company's liquidity and interest payments.

The procedure to obtain discretionary relief is contrary to explicit case law of the Court of Justice. As the Court emphasized in *Factortame*, the mere fact that competent authorities are empowered to grant exemptions or dispensations from the application of a discriminatory national law does not eliminate the discriminatory content of the measure, even if the power in question is in fact freely applied.[170] Thus, the ownership percentage test leads to discrimination against non-nationals and restricts their freedom of establishment.[171]

C. Possible Arguments for Justification

A review of the Court's case law shows that there is no possible justification for the restriction caused by the limitation on benefits clause. Since no litigation against the provision in dispute has yet been brought before the Court, possible justifications employed in other cases must be analyzed.

1. Fiscal Residence

Reference to the taxpayer's fiscal residence as a criterion for differentiation is an invalid defense. The criterion for residence can be rather similar to that of nationality in its practical results. Therefore, discrimination based on residence can only be justified if there is an objective difference between residents and non-residents.

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[168] *See* Rev. Proc. 96-13, 1996-3 I.R.B. 31. *See also* Patricia R. Lesser, *Access to Tax Treaty Benefits: Procedural Aspects*, 17 TAX MGMT. INT'L FORUM 38, 43-44 (1996).

[169] *See* Rev. Proc. 96-13, 1996-3 I.R.B. 31. In contrast, the Memorandum permits advance determinations. *See* Memorandum, *supra* note 158.

[170] Case C-221/89, Regina v. Secretary of State for Transport *ex parte* Factortame Ltd. (II), 1991 E.C.R. I-3905, I-3968-69, paras. 37-39, [1991] 3 C.M.L.R. 589, 629-30, paras. 37-39; *see also* Case 27/80, Fietje, 1980 E.C.R. 3839, 3854-55, para. 14, [1981] 3 C.M.L.R. 722, 739-40, para. 14.

[171] *See* Pöllath, *supra* note 46, at 178; Eilers & Brügmann, *supra* note 156, at 19-20; Jörg Mössner, *Anti-Abuse Provisions in the German Tax Treaties*, *in* Essers & Offermanns, *supra* note 54, at 76-77.

The Court dealt with fiscal residence as a justification for discriminatory measures in *Commerzbank*.[172] A bank with residence in Germany mistakenly overpaid taxes levied by the United Kingdom on the German bank's U.S. source income. Yet, this income was exempt from taxation under the U.S.-U.K. Tax Treaty because the requirement of U.K. residence was not met. The bank was repaid the net amount of the overpayment. The United Kingdom failed to pay interest on that amount, the so-called repayment supplement, because the U.K. Income and Corporation Taxes Act 1988 restricted this supplement to U.K. resident companies.[173] After considering the unequal treatment of resident and non-resident companies, the Court held that the provision was discriminatory because most non-resident companies were foreign companies whereas U.K. companies could easily meet the residence requirement.[174]

In *Schumacker*,[175] a taxpayer worked in Germany but lived in Belgium. According to a tax treaty between Germany and Belgium, he was taxed in Germany. As a non-resident, he was not allowed tax benefits to the same extent as a resident of Germany. Again, the Court held that in most instances, residents and non-residents were not in comparable situations but that in this case their situation was comparable and led to an unjustified infringement.[176]

Under the ownership percentage test, the Treaty qualification of the company is derived from the residence of the ultimate owners in the contracting states. However, the Treaty does not set up different rules for residents and non-residents similar to national tax laws. Instead, only resident companies can qualify, and the Treaty is irrelevant for non-resident companies. So the treatment of resident and non-resident companies does not differ on the basis of their nationality.

2. *Cohesion of the Tax System*

A justification for the ownership percentage test based on maintaining the cohesion of the U.S.-German Treaty also fails to support the Treaty's discriminatory effects. The cohesion of a tax system is a concept developed

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[172] Case C-330/91, Regina v. Inland Revenue Commissioners *ex parte* Commerzbank AG, 1993 E.C.R. I-4017, [1993] 3 C.M.L.R. 457.

[173] *See id.*

[174] *See Commerzbank*, 1993 E.C.R. at I-4044, paras. 18-20, [1993] 3 C.M.L.R. at 474, paras. 18-20.

[175] Case C-279/93, Finanzamt Köln-Altstadt v. Roland Schumacker, 1995 E.C.R. I-225, [1996] 2 C.M.L.R. 450. This decision was followed in other cases. *See* Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, [1995] 3 C.M.L.R. 85; Case C-107/94, Asscher v. Staatssecretaris Van Financiën, 1996 E.C.R. I-3089, [1996] 3 C.M.L.R. 61.

[176] *See Schumacker*, 1995 E.C.R. at I-266, para. 58, [1996] 2 C.M.L.R. at 479, para. 58.

by the Court.[177] It allows Member States to treat EU nationals worse than domestic taxpayers in order to maintain a balanced tax law system. Cohesion attempts to keep the balance of the tax system on a technical level. Characterization of tax-relevant items should be the same throughout a tax system. If, for example, income characterization and deduction allowance cannot be offset because the facts of a particular case allow special provisions designed for non-nationals, the technical balance of the system may be at danger.

In the *Bachmann* case,[178] the Court of Justice used the principle of cohesion for the first time. A German national working in Belgium sought deductions for various insurance premiums he had paid to German insurance companies but was only allowed to deduct premiums paid to Belgian insurance companies. According to the Belgian tax code, premiums were only deductible if the proceeds of the insurance policies were subject to Belgian taxation. The Court held that this was an infringement on the taxpayer.[179] Yet, the Court recognized that the cohesion of the Belgian tax system would be endangered, if the deductions in dispute did not correspond with taxable income from their proceeds. So, the Court ruled that the infringement was sufficiently justified because it was impossible to ensure the cohesion of the national tax system by means of measures that were less restrictive.[180]

In the *Wielockx* case,[181] the Court extended the principle of cohesion to tax treaties. The EC Treaty does not prohibit Member States from concluding tax treaties with each other and even encourages such behavior. Article 220 provides that Member States shall enter into negotiations with the goal of abolishing double taxation within the European Union. As the Court pointed out, bilateral cohesion reached by operation of tax treaties prevented a Member State from pleading the defense of cohesion on a national level.[182] A tax treaty therefore is an acceptable means of ensuring cohesion of national tax laws.

Regarding the ownership percentage test, however, the cohesion of the U.S. or German tax system is not at stake. Tax treaties are different from national tax laws because treaties have no underlying cohesion them-

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[177] *See* Case C-204/90, Bachmann v. Belgian State, 1992 E.C.R. I-249, I-282-83, paras. 21-27, [1993] 1 C.M.L.R. 785, 808-09, paras. 21-27.

[178] *Bachmann*, 1992 E.C.R. I-249, [1993] 1 C.M.L.R. 785.

[179] *See id.* In this case, Article 48 of the EC Treaty, providing for the free movement of workers, was affected. However, the same considerations apply to situations under Article 52 of the EC Treaty.

[180] *See Bachmann*, 1992 E.C.R. at I-283, para. 27, [1993] 1 C.M.L.R. at 809, para. 27.

[181] Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, [1995] 3 C.M.L.R. 85.

[182] *See Wielockx*, 1995 E.C.R. at 2517, para. 25, [1995] C.M.L.R. at 101, para. 25.

selves.[183] There is a balance of mutual concessions by taxing authorities in a tax treaty. Yet, this balance is not a technical one in the sense of matching assets being offset against each other.[184] A tax asset balance can only be derived from national law as modified by a treaty, not from a treaty itself, because the treaty is dependent on the national tax law system.[185] Concessions made in a treaty are not a basis for cohesion. They are mutual as far as they are made in a *do ut des* mode during the negotiation. But when applied to cases, the concessions are independent from each other. A waiver of taxing authority is made in order to tax only the income most closely related to the source, not to consider any other income or deduction at the same time. This waiver cannot be offset against the reciprocal waiver of the other contracting state. As the Court pointed out in *Commission v. France*, the scope of Article 52 of the EC Treaty may not be restricted by any reciprocity clause.[186] Treaty shopping may be disfavored for the same reasons as the lack of cohesion in national laws, namely revenue losses. Yet, treaty shopping does not disturb a country's tax system cohesion.

3. *Administrative Difficulties*

German tax authorities cannot plead administrative difficulties as a justification for applying the limitation on benefits clause, because the Court of Justice has found that the prohibition of discrimination is more important than administrative burdens in the tax assessment procedure. As the Court held in *Halliburton*,[187] administrative difficulties do not justify discriminative measures. In this case, Dutch tax authorities dealt with an exemption from Netherlands tax on land transfer. Land transfers as a result of corporate restructuring were exempted from such tax. One member of the Halliburton group was incorporated in Germany under German law. The Dutch tax authorities denied an exemption on these grounds and argued

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[183] *See* Hinnekens, *supra* note 50, at 151. *But see* van Unnik & Boudesteijn, *supra* note 54, at 113 (arguing that similar discrimination by the U.S.-Dutch Treaty is justified on the basis of its cohesion). *See also* Gallo, *supra* note 54, at 651, on the relationship between tax treaties and European Union law obligations.

[184] In the mentioned cases the principle of cohesion aimed at offsetting categories of levy that were directly related to each other. Yet, different kinds of levies cannot be offset in this sense, as pointed out in the most recent decision in this field. Case C-107/94, Asscher v. Staatssecretaris Van Financiën, Opinion Léger, 1996 E.C.R. I-3089, I-3104-06, paras. 81-88, [1996] 3 C.M.L.R. 61, 76-77, paras. 81-88.

[185] *See* Peter J. Wattel, *The EC Court's Attempts to Reconcile the Treaty Freedoms with International Tax Law*, 33 COMMON MKT. L. REV. 223, 238-42 (1996) (discussing the relationship between tax treaties and national law in the cohesion concept of the Court of Justice).

[186] Case 270/83, Commission v. France, 1986 E.C.R. 273, 307, para. 26, [1987] 1 C.M.L.R. 401, 423, para. 26. *See also* Case C-101/94, Commission v. Italian Republic, 1996 E.C.R. I-2691, I-2727, para. 27, [1996] 3 C.M.L.R. 754, 782, para. 27.

[187] Case C-1/93, Halliburton Services BV v. Staatssecretaris van Financiën, 1994 E.C.R. I-1137, [1994] 3 C.M.L.R. 377.

that they had been unable to determine whether the concerned German entities were comparable to the Dutch types of entities. The Court did not follow this argument and dismissed the case. It found no legal merit in the Dutch government's argument concerning cost and effort concerns and pointed out that the duty to carry out all necessary verification rested with the government.[188]

Verification problems in the context of the ownership percentage test could occur in cases of both direct or indirect ownership. If a foreign national directly holds shares in a German company, the tax authorities do not face a problem because the direct ownership can easily be proved. Indirect ownership, however, can be more complicated. It consists of a multi-tier structure and can include several entities incorporated in other Member States, although the majority of shares may ultimately lie in the hands of a German or U.S. individual. Accordingly, national tax authorities have to check the ownership proportions of the involved foreign companies. Therefore, they may argue that it would be even more difficult to conduct this investigation if the ownership test also comprised non-national entities. Yet, the initial burden of proof is not on the authorities but on the taxpayer as determined by national law. German tax procedure law requires the taxpayer to give proof of all relevant circumstances in cross-border cases.[189] So, the investigation would be prepared by the taxpayer and submitted to the authorities. If the authorities should still have doubts about ownership percentages in foreign companies, they could rely on the EC Directive on mutual assistance to obtain further necessary information or to verify the information given by the taxpayer.[190] As stated in the *Halliburton* case, the authorities, if in doubt, need to rely on this Directive.[191] The authorities even have to bear all costs for the procedure.[192] In sum, administrative difficulties presented by certain tax procedures do not justify the exclusion of non-national entities from the scope of the ownership percentage test.

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[188] *See Halliburton Services*, 1994 E.C.R. at I-1157, para. 22, [1994] 3 C.M.L.R. at 392, para. 22.

[189] *See* AO, *supra* note 65, § 90(2).

[190] *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 and value added tax, 1977 O.J. (L 336) 15, *as amended by* Council Directive 79/1070/EEC of 6 December 1979, 1979 O.J. (L 331) 8.

[191] *Halliburton Services,* 1994 E.C.R. at I-1157, para. 22, [1994] 3 C.M.L.R. at 392, para. 22. *See also* Case C-80/94, Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493, I-2517, para. 26, [1995] 3 C.M.L.R. 85, 101, para. 26.

[192] *See* Frans Vanistendael, *The Consequences of Schumacker and Wielockx: Two Steps forward in the Tax Procession of Echternach*, 33 COMMON MKT. L. REV. 255, 266-68 (1996).

4. *The Rule of Reason*

As these cases show, none of the specific justifications that the Court analyzed in tax cases in making its decisions can be precisely employed to save Article 28 of the Treaty from violating the EC Treaty. However, this result still leaves open the way for a general justification. Using the Court's decisions as a guideline, general justifications can also be analyzed. Even so, no general justification derived from the Court's rules can defend Article 28.

Many decisions of the Court employ a general rule of reason as a justification for the decisions.[193] Decisions on tax matters fit into these public policy considerations as they form special cases of this general rule of reason, for example, cases such as the principle of cohesion[194] or the consideration of comparability of residents and non-residents.[195] The rule applied must be suitable for attaining its objective.[196] There must be an objective necessity and proportionality for the rule in question; in other words, the Court verifies that the rule is not unreasonable by showing that there is no other way of regulating the matter which would affect EC Treaty freedoms less strongly.[197] Therefore, a discrimination can be justified if it is based on a legitimate objective goal, if it is suitable for attaining this goal, and if the discrimination is proportionate to this goal.[198]

a. The Legitimate Goal of the Ownership Percentage Test

The discriminatory ownership percentage test will meet the general rule of reason if, first, it is based on a legitimate goal. As with all limitation on benefits provisions, the ownership percentage test may be considered as a legitimate goal because it aims at the prevention of treaty shopping as disfavored fiscal behavior.[199] Every country that is party to a tax treaty has a strong interest in preventing treaty shopping. The treaty parties want to discourage treaty shopping for various reasons, and a limitation on benefit clause is a mechanism for this prevention. From the view of these parties,

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[193] *See, e.g.*, Case 120/78, Rewe-Zentrale AG v. Bundesmonopolverwaltung für Branntwein, 1979 E.C.R. 649, [1979] 3 C.M.L.R. 494.

[194] *See* Case C-204/90, Bachmann v. Belgian State, 1992 E.C.R. I-249, I-282-83, paras. 21-27, [1993] 1 C.M.L.R. 785, 808-09, paras. 21-27; *Wielockx*, 1995 E.C.R. at I-2516-17, paras. 23-25, [1995] 3 C.M.L.R. at 100-01, para. 23-25.

[195] *See* Case C-330/91, Regina v. Inland Revenue Commissioners *ex parte* Commerzbank AG, 1993 E.C.R. I-4017, [1993] 3 C.M.L.R. 457; Case C-279/93, Finanzamt Köln-Altstadt v. Roland Schumacker, 1995 E.C.R. I-225, [1996] 2 C.M.L.R. 450.

[196] *See* Case C-19/92, Kraus v. Land Baden-Württemberg, 1993 E.C.R. I-1663, I-1697, para. 32.

[197] *See id.*

[198] *See id.*; Case C-55/94, Gebhard v. Consiglio Dell'Ordine Degli Avvocati E Procurator Di Milano, 1995 E.C.R. I-4165, I-4197-98, para. 37, [1996] 1 C.M.L.R. 603, 628, para. 37.

[199] *See* Sascha Prechal, *Aspects of European Law*, *in* Essers & Offermanns, *supra* note 54, at 69, 71.

and especially from a U.S. standpoint, treaty shopping prevention is therefore a legitimate aim. However, whether treaty shopping is objectively really harmful, and therefore a legitimate goal, is a disputed question.

Parties to tax treaties usually disfavor treaty shopping for several reasons. The most obvious reason is simply that treaty shopping could mean a loss of revenue to the treaty parties.[200] One of the contracting states, usually the source country, has waived or lessened its claim to tax. To the extent that taxpayers are able to utilize these allowances, the waiving country's revenue will be reduced.[201] Since this country's revenue is higher if only treaty country nationals use the treaty, there is a loss caused by treaty shopping.

The informality of treaty abuse presents another disadvantage. The ultimate owners of conduit companies, because they are residents of third countries, are not subject to any tax assessment or procedure in the contracting states. They are not covered by the treaty-based exchange of information systems between these states.[202] This lack of control may lead to further tax evasion which remains undetected and, therefore, unprevented.[203]

Next, taking advantage of favorable treaty provisions is regarded as a privilege of the contracting states' nationals. The contracting states make reciprocal concessions on their tax authority in order to serve their nationals, not the nationals of third states.[204] Treaty shopping exploits these mutual commitments because a treaty shopper profits from them although the treaty shopper's own country is not involved in that treaty and has not made any concession in return. Unintended beneficiaries who utilize treaties in combination with no-tax or low-tax jurisdictions act beyond the treaties' purpose of alleviating double taxation.[205] Treaty shoppers can be seen as "free-riders" on the treaty.

Also, countries that lack or have a less favorable treaty with other countries will not be motivated to negotiate and conclude future treaties.[206] There is no incentive to enter into a treaty and make any concessions if a country's residents are able to benefit from other treaties by way of treaty shopping. In turn, this limits other countries' incentives to establish an extensive treaty network from which their nationals would benefit.[207] If a

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[200] *See* Haug, *supra* note 32, at 216.

[201] *See id.*

[202] *See, e.g.*, U.S. Model Treaty, art. 26, *supra* note 23 (providing that the competent authorities shall exchange information that is relevant for carrying out the obligations of treaty provisions as well as domestic tax laws).

[203] *See* van Herksen, *supra* note, at 20.

[204] *See* Haug, *supra* note 32, at 218.

[205] *See id.*

[206] *See id.* at 219.

[207] *See* H. David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy*, 19 COLUM. J. TRANSNAT'L L. 359, 360-369 (1981).

country enters treaty negotiations and its nationals already benefit from other treaties, bargaining power is skewed in favor of the treaty shopping country. That country will want to have a treaty at least as favorable as the other treaties from which its nationals already benefit, or it will be able to gain other concessions it would not normally receive.[208]

Finally, treaty countries may be reluctant to expand their treaty network because they fear multiplying already existing treaty abuses. In the absence of any prevention, each treaty entered into potentially becomes a treaty with the whole world.[209] So, any country that has entered into tax treaties and has waived parts of its sovereignty seeks to curb or eliminate treaty shopping.

However, these arguments against treaty shopping are contested. An argument against stringent prevention of treaty shopping is that, in general, such prevention is protectionistic and hinders economic integration. Many countries, including the United States and Germany, are trying to stimulate economic growth by integrating with other countries in their region.[210] Anti-treaty shopping clauses and regional economic integration policies, however, have contrary objectives. While anti-treaty shopping clauses actually intend, roughly speaking, to keep foreign companies out of a country, efforts at regional economic integration such as the European Union and the North American Free Trade Association have achieved a common, borderless market in which companies can freely move.[211] Existing anti-treaty shopping clauses clearly have a negative effect on EU policies that pursue free intra-EU trade.[212] If the legal framework makes an investment in a for-

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[208] *See id.*

[209] For example, the Netherlands Antilles used to be a preferred country for treaty shopping. The 1948 Treaty between the United States and the Netherlands was extended to the Netherlands Antilles by a Protocol in 1955 but the United States terminated this extension in 1987, effective as of Jan. 1, 1988. Convention Between the United States of America and the Kingdom of the Netherlands with Respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, U.S.-Neth., *reprinted in* 2 Tax Treaties (CCH) ¶ 6203. However, the notice of termination has been modified, and the Treaty partly continues in force. A new treaty with a limitation on benefits clause was signed in 1986 but is not yet in effect. Convention Between the Government of the United States of America and the Government of the Kingdom of the Netherlands in Respect of the Netherlands Antilles for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 8, 1986, U.S.-Neth., *reprinted in* 2 Tax Treaties (CCH) ¶ 6603; *see also* Frith Crandall, *The Termination of the United States-Netherlands Antilles Tax Treaty: What Were the Costs of Ending Treaty Shopping*?, 9 NW. J. INT'L L. & BUS. 355, 357 (1988); Roger Lorence, *Will the World Follow the U.S. Lead on Limitation of Treaty Benefits*?, 7 J. INT'L TAX'N 124, 126 (1996).

[210] It is this motive that led to the foundation of the European Union and the North American Free Trade Association.

[211] *See* EC TREATY arts. 2, 3 (stating these goals).

[212] However, the harmful effects of anti-treaty shopping clauses depend on the level of economic integration. Once the European Union has completely harmonized its treaties with

eign country unattractive, companies will place this investment somewhere else. Therefore, strong anti-treaty shopping clauses can restrict the movement of European companies within the EU. Together with unpredictable application of these clauses and the remedies against them, anti-treaty shopping clauses could discourage companies from investing within the regionally integrated area. Instead of tackling the problems of these clauses, restructuring the organization, or taking other remedies, companies may simply invest in a different country.[213] Since income for the company means revenue for the country, this results in budgetary losses that probably exceed the losses created by treaty abuse. A small revenue loss concerning dividend income may be outweighed by a greater gain from other items of income, and taxes other than income taxes. Thus, it is argued that the prevention of treaty shopping has an adverse effect on investment which may outweigh the revenue losses.[214]

Preventing economic integration by the use of anti-treaty shopping laws may also have more far-reaching results than the loss of income tax revenue. The conduit companies' investments that are banned by anti-treaty shopping rules may have positive economic, social, and infrastructural effects on the place of investment.[215]

Another argument that weakens the rationale of treaty shopping prevention is that the more extended a country's treaty network, the less likely it is that treaty shopping will occur.[216] If a country maintains a considerable number of treaties with other countries, investors from all these countries can take advantage of these treaties as treaty nationals, not as treaty shoppers from outside. A country offering its nationals many treaties makes treaty shopping unnecessary. The incentive to engage in treaty shopping, i.e., to find a treaty elsewhere, diminishes with the number of treaties available.[217]

Additionally, revenue losses can also occur because the administration of anti-treaty shopping laws is costly due to their complex and partly inefficient provisions.[218] These costs can outweigh the benefits of treaty shopping prevention, especially because treaty shopping does not seem to occur

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the United States or concluded a single U.S.-EU Treaty, treaty shopping will no longer hinder further integration within the EU.

[213] Treaty shopping prevention might eliminate the incentive for foreign investment. *See, e.g.*, Gild, *supra* note 166, at 581.

[214] *See* Haug, *supra* note 32, at 279, 280, 285.

[215] *See id.*

[216] *See id.* at 281.

[217] *See id.* The United States, for example, has an extended system of tax treaties. As of January 31, 1997, the United States had 56 income tax treaties in force. *See, e.g.*, Fogarasi et al., *supra* note 31 (listing those treaties).

[218] *See* Haug, *supra* note 32, at 283, 284.

very extensively in practice but anti-treaty shopping law nevertheless has deterrent effects on investment.[219]

Finally, it can be argued that the objective to curtail treaty shopping further deepens discrepancies between treaty law and national law. On the level of treaty law, no perfect solution against treaty shopping has been found. National law, on the other hand, only supplements treaty law in this respect. Accordingly, countries implement specific anti-treaty shopping laws into their national law system which are incomplete. This implementation, in turn, makes it more difficult to harmonize the different treaty solutions. Such harmonization, however, is desirable as an effort to prevent treaty override.[220]

The arguments for and against treaty shopping prevention show that a common rationale behind treaty shopping prevention is difficult to find. Additionally, rationales mainly determine the public policy of the United States, a non-Member State of the EU, much more than Germany's policy. It could be questioned whether Germany can raise its own arguments for treaty shopping prevention when it only agreed to the stringent U.S. treaty policy in order to have a treaty negotiated.[221] Consequently, Germany would lack a legitimate goal for applying the ownership percentage test. In all, the purpose of treaty shopping prevention policies, and with it the legitimacy of discriminatory prevention measures, appear to be questionable.

b. The Proportionality of the Ownership Percentage Test

Even if is assumed that treaty shopping prevention is a legitimate goal, the ownership percentage test is not a proportionate means to attain this goal. Rather, a more detailed treaty shopping test, which considers the actual economic links between a country and a corporation, is more suitable to serve the goal of treaty shopping prevention.[222] Economic links between a company and its place of business are legal criteria acknowledged by the Court. For example, the Court held in *Jaderow* that a Member State, in authorizing fishing vessels to fish against national quotas, may stipulate license conditions that ensure a real economic link between the vessel and the flag state.[223]

Moreover, the proof of economic links of a corporation to a particular country (an "establishment") is not only permissible but also imperative. As mentioned in *Daily Mail*, the concept of establishment always implies a minimum genuine economic link, i.e., it requires any economic activity as

[219] It is remarkable that there are apparently no cases that invoke the complex limitation on benefits provisions in the treaties. *See, e.g.*, Haug, *supra* note 32, at 284.

[220] *See supra* note 68 (discussing treaty override).

[221] *See* Hinnekens, *supra* note 50, at 152.

[222] *See* Essers & Offermanns, *supra* note 54, at 82; Hinnekens, *supra* note 50 , at 164.

[223] Case C-216/87, Regina v. Ministry of Agriculture, Fisheries and Food *ex parte* Jaderow Ltd., 1989 E.C.R. 4509, 4544, para. 26, [1991] 2 C.M.L.R. 556, 578, para. 26.

opposed to the mere registration of a company as a "paper subsidiary."[224] This minimum requirement was set up in that case to draw a line between establishments and mere transfers of parts of the management of a company. Article 52 of the EC Treaty is only applicable to economically existing establishments, not to sham companies.[225]

Given this standard of proportionality based on economic links, the ownership percentage test is not proportionate. As the structure of Article 28 shows, the intent to treaty shop cannot reliably be identified by just one test.[226] However, a test that is not sufficient for identification cannot fulfill the criterion of proportionality. The application of the ownership percentage test may be easy, quick, and inexpensive for the tax authorities which, in turn, potentially benefits the taxpayer. To a certain extent, it is even fair to have a standard precisely defined by a percentage of ownership because this standard is based on an objective criterion. Yet, these considerations may be well-founded for the treatment of non-EU countries but cannot meet the higher demands of non-discrimination within the EU as stated by the EC Treaty.[227] In an economic environment determined by cross-border trade and international corporate structures, a mere percentage of ownership cannot demonstrate any economic links. Moreover, it is arbitrary to set this link at a fifty percent threshold which neglects several common functions of companies. Non-German owned companies for holding, financing,[228] or licensing purposes may have extensive management functions. Holding companies are set up to centralize management and to separate business operations due to liability reasons. This corporate structure is even promoted in other places in tax systems.[229] Although there are valid business and legal considerations for the existence of holding companies, they face difficulties in qualifying for Treaty benefits because they cannot prove an active conduct of business in the concerned country of residence, as required by one of the alternative tests in Article 28 of the U.S.-German Treaty.[230] It is also not possible to have an intra-EU joint venture of three parties from different Member States that participate equally in the venture and still qualify

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[224] Case 81/87, Regina v. H.M. Treasury and Commissioners of Inland Revenue *ex parte* Daily Mail and General Trust plc, Opinion Darmon, 1988 E.C.R. 5483, 5501, para. 5, [1988] 3 C.M.L.R. 713, 717, para. 5.

[225] *See id.*

[226] *See* U.S.-German Treaty, *supra* note 1, art. 28, ¶ 3249.57. The provision includes six different tests for treaty qualification. Other treaties have even more complicated tests. *See, e.g.*, U.S.-Dutch Treaty, art. 26, *supra* note 52.

[227] *See, e.g.*, EC TREATY arts. 2, 3, 5.

[228] Due to free capital flows in Europe, ensured by the EC Treaty, many companies raise their capital from multiple jurisdictions.

[229] Under U.S. law, for example, certain company structures may be allowed to file a consolidated return and receive preferential treatment of dividends. I.R.C. §§ 1501, 243.

[230] *See* U.S.-German Treaty, *supra* note 1, art. 28(1)(c), ¶ 3249.57. Article 28(1)(c), the so-called active conduct of business test, excludes "the business of making or managing investments" which leaves little room for qualification by a holding company. *Id.*

for the ownership percentage test.[231] A substantial business nexus between a company and its country of registration can be better proved by a test that reviews in detail the activities of the company and their underlying business purposes. Concerning the predictability of the tests in Article 28(1), it is not sufficient to operate with wide definitions and narrow their scope in a noncommittal Memorandum to the Treaty in the hope that the tests can easily be handled once the Treaty is in force.[232] Thus, the ownership percentage test is not a proportionate rule and cannot be justified under general considerations set up by the Court.

c. The Role of the Alternative Tests in Article 28

The fact that Article 28(1) offers a variety of alternative tests still does not eliminate the disproportionality of the ownership percentage test.[233] These tests, regarded separately, might conform to European Union law, but Article 28(1) as a whole is discriminatory even if it only contains one discriminatory test.

No strong arguments for discrimination can be made with respect to the active conduct of business test in Article 28(1)(c).[234] It seems proportionate to set up a test that is oriented toward the activities of a company and regards their substance as more important than the formal ownership structure. However, the exclusion of holdings in Article 28(1)(c) seems to be contrary to European Union law.[235] Article 28(1)(d), the stock exchange test, requires that the shares of a corporation be substantially and regularly traded on a recognized stock exchange.[236] This test affects the company's choice of where its shares are quoted. However, this requirement appears to be the same for host country companies and, therefore, not discriminatory.[237] The other tests in Article 28(1) which seek to identify treaty shoppers and qualify individuals, contracting states and not-for-profit organizations are not discriminatory.[238] From a foreign-owned company's point of view, the requirements of these tests are not harder to meet than for a company owned by Treaty nationals. Both companies must fulfill the same requirements. The tests do not openly differentiate on the basis of nationality. They also do not constitute hidden discrimination in the sense

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[231] *See* Marianne Burge & Dieter Endres, *Treaty Shopping: the New German-US Treaty Raises more Questions than it Answers*, 18 INTERTAX 547 (1990) (analyzing Article 28 of the U.S.-German Treaty with special regard to the impact on joint ventures).

[232] *See supra* note 166.

[233] *See* U.S.-German Treaty, *supra* note 1, art. 28(1), ¶ 3249.57.

[234] *See* U.S.-German Treaty, *supra* note 1, art. 28(1)(c), ¶ 3249.57.

[235] *See supra* text accompanying notes 238-40.

[236] *See* U.S.-German Treaty, *supra* note 1, art. 28(1)(d), ¶ 3249.57.

[237] But see Eric Kemmeren, *Anti-Abuse Provisions in the Dutch Tax Treaties*, *in* Essers & Offermanns, *supra* note 54, at 73, arguing that a similar clause in the U.S.-Dutch Treaty infringes on the freedoms of the EC Treaty.

[238] *See* U.S.-German Treaty, *supra* note 1, art. 28(1)(a), (b), and (f), ¶ 3249.57.

that it is particularly difficult for foreign-owned companies to meet the tests. They treat nationals and non-nationals equally.

However, these tests are designed as alternatives. A corporation may fulfill any of the conditions in order to qualify. Instead of meeting the requirements of the ownership percentage test, one may argue, companies have the opportunity to alternatively fulfill one of the other tests. Again, though, foreigners are not accorded treatment comparable to Treaty nationals. Instead of handling each test separately, the provision must be seen as a whole. It cannot be split into single tests on the basis that a company which is discriminated against under one test can still switch to another test. Two arguments support this view.

First, referring a disqualified company to alternative tests is "liable to hinder or make less attractive the exercise of the basic freedoms."[239] It restricts a company's choice of tests and is an additional obstacle for non-Treaty EU nationals who cannot freely choose the test by which they qualify for Treaty benefits.[240] Loss of the ability to choose one of the alternative tests because of discrimination is, itself, discrimination. To a non-national owner of the company, having no "free choice" (as nationals have) may make the establishment of a company less attractive and less predictable. This adversely affects the company's potential to do business solely under economic considerations. Accordingly, the company may change the target country of its investment which is exactly what the EC Treaty intends to avoid.[241]

Second, while a certain ownership percentage is a "hard" factor with clear-cut benchmarks and may be easy to verify, the taxpayer faces a stronger burden of proof in the other tests, at least on the level of the discretionary relief procedure, and the taxpayer is more liable to be rejected. For example, a company only dealing with passive investments cannot pass the active conduct of business test because the test excludes "the business of making or managing investments."[242] If this company is owned by non-nationals, the overall barriers to the treaty benefits are higher than they are for an equivalent German company.

5. *The Public Policy Exception in Article 56*

Article 56 of the EC Treaty allows Member States to limit the right of free establishment for public policy reasons.[243] However, Germany cannot

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[239] Case C-19/92, Kraus v. Land Baden-Württemberg, 1993 E.C.R. I-1663, I-1697, para. 32.

[240] *See* Becker & Thömmes, *supra* note 156, at 567.

[241] One of the objectives of the common market of the European Union is the abolition of obstacles to the free movement of persons. EC TREATY art. 3(c).

[242] U.S.-German Treaty, *supra* note 1, art. 28(1)(c), ¶ 3249.57.

[243] *See* EC TREATY art. 56. The first paragraph of the Article reads "1. The provisions of this Chapter and measures taken in pursuance thereof shall not prejudice the applicability of

rely on this public policy exception to uphold the ownership percentage test in the U.S.-German Treaty. The Court of Justice held in *Rutili* that Member States are, in principle, free to determine the requirements of public policy according to their national needs.[244] However, a concept of public policy, as an exception to one of the fundamental freedoms of the EC Treaty, must be interpreted strictly.[245] The scope of that exception cannot be defined unilaterally by a Member State but must be subject to control by the institutions of the European Union.[246] Therefore, public policy only allows an unequal treatment if it serves an acknowledged purpose, and is more than just a national limitation of the fundamental freedoms mandated under European Union law.

The mere probability of tax evasion by treaty shopping is not an acknowledged policy in this sense. In *Commission v. France*, the French government tried to defend a national law which gave a tax credit to French subsidiaries of foreign companies, but not to agencies and branches established in France by foreign companies.[247] The French government argued that, without this discriminatory treatment, branches and agencies would be at an advantage compared to subsidiaries.[248] Foreign companies would include shares of French companies in the assets of their agencies to benefit from the tax credit, which would enhance the danger of tax evasion. The European Commission, however, showed in the proceedings of the case that this tax strategy would increase the tax burden on foreign companies, instead of reducing the French tax revenue.[249] This case shows that the danger of tax evasion is generally a permissible national concern but has to be proven in each case. It is not sufficient to rely on the danger of tax evasion and design laws to prevent this, if there is in fact no such danger.

This rule applied to the ownership percentage test would first require that the danger of tax evasion by treaty shopping be an underlying concern of the ownership percentage test. From an U.S. point of view, the implementation of anti-treaty shopping clauses serves the avoidance of tax evasion and can be regarded as a public policy of the United States.[250]

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provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on grounds of public policy, public security or public health." *Id.*

[244] Case 36/75, Rutili v. Minister for the Interior, 1975 E.C.R. 1219, 1231, para. 26, [1976] 1 C.M.L.R. 140, 155, para. 26. The case dealt with Article 48(3) of the EC Treaty, a public policy exception to Article 48(1) which guarantees the free movement of workers within the EU. EC TREATY art. 48. However, the same considerations can be applied to the public policy exception to the freedom of establishment.

[245] *See* Case 36/75, Rutili v. Minister for the Interior, 1975 E.C.R. 1219, 1231, para. 27, [1976] 1 C.M.L.R. 140, 155, para. 27.

[246] *See id.*

[247] Case 270/83, Commission v. France, 1986 E.C.R. 273, 299-300, paras. 2-6, [1987] 1 C.M.L.R. 401, 416-17, paras. 2-6.

[248] *See id.*

[249] *See id.*

[250] *See supra* text accompanying notes 37-40.

Germany, however, the other contracting state, perhaps did not want anti-treaty shopping laws and only agreed to the U.S. policy to reach other concessions in return. At the very least, Germany did not have strong concerns about treaty shopping when it concluded the U.S.-German Treaty.[251] Given that the strict standard of Article 56 of the EC Treaty requires that public policy exceptions be construed narrowly, this mere toleration of another country's public policy, or even its expressed protection, might not be a sufficient public policy for Germany itself. Therefore, Germany will face difficulties in establishing the concern about treaty shopping, and tax evasion related thereto, as its national public policy.[252]

Second, there must be in fact a danger of tax evasion by treaty shopping. To come under the public policy exception of Article 56 of the EC Treaty, a country has to demonstrate concretely the foundation of its anti-treaty shopping laws. Before treaty shopping prevention can be regarded as a public policy, a cost-benefit analysis of limitation on benefits clauses will be required, as well as statistics demonstrating that treaty shopping really occurs in practice. It will be difficult to give such evidence because it is highly disputed whether treaty shopping is harmful at all.[253] Therefore, the Court is unlikely to uphold the ownership percentage test as justified on grounds of public policy.

III. POSSIBLE SOLUTIONS TO THE CONFLICT

Possible solutions to the conflict of Article 28 with European Union law are to renegotiate the U.S.-German Treaty, or negotiate a treaty between the United States and the European Union replacing all bilateral treaties. However, a company that is affected by the U.S.-German Treaty can hardly invoke these solutions, and they would come too late to eliminate the company's current tax disadvantages. At present, companies can only seek legal remedies before the courts. Under German law, the taxpayer can file a formal protest with a local tax office,[254] bring an action before a tax court,[255] and finally appeal on points of law.[256] Under European Union law, a preliminary ruling of the Court of Justice can be invoked by a national court to

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[251] *See* Hinnekens, *supra* note 50, at 152.

[252] *See* BEN TERRA & PETER WATTEL, EUROPEAN TAX LAW 47 (1993) (questioning whether Germany can claim a public policy interest in avoiding treaty shopping if the purpose of the limitation on benefits provision of the U.S.-German Treaty is to protect the tax system of the United States).

[253] *See supra* text accompanying notes 210-21

[254] *See* AO, *supra* note 65, §§ 347, 348. The protest is filed with the local tax office which issued the assessment notice. It commences an administrative procedure which is a mandatory prerequisite for the taxpayer's later standing in actions brought before the tax court.

[255] *See* Finanzgerichtsordnung [Tax Court Procedure Code] [FGO] §§ 40, 41. The competent court is the lower tax court in the state in which the taxpayer resides.

[256] *See* FGO §§ 115-127. The appeal is brought to the Federal Tax Court.

clarify the question of a violation of Community law.[257] The European Commission, perhaps prompted by a taxpayer in a Member State, can initiate proceedings before the Court against Germany on the basis of Germany's violation of the EC Treaty.[258] Under the U.S.-German Treaty itself, a remedy called a "mutual agreement procedure" is available. This is a sort of continuation of a taxpayer's request for discretionary relief under Article 28(2) and leads into an arbitration procedure.[259] However, all these remedies do not seem appropriate to solve the conflict between European Union law and the Treaty. They are limited to individual cases and do not change the U.S.-German Treaty or a country's treaty policy. Moreover, the remedies do not have much chance of success because both parties to the U.S.-German Treaty seem determined to apply the Treaty unchanged, and they refer to discretionary relief as the sole remedy for individuals.[260]

A. Renegotiation of the U.S.-German Treaty

In view of the conflict between the U.S.-German Treaty and European Union law, renegotiation of the Treaty seems inevitable.[261] Germany must amend its Treaty with the United States because Article 5 of the EC Treaty demands that Member States take all appropriate measures to ensure fulfillment of the obligations of the EC Treaty, including the guarantee of the freedom of establishment which is impeded by the U.S.-German Treaty.[262]

1. The Necessity of a Limitation on Benefit Clause

The easiest solution to the problem is to enter into renegotiations with the aim of removing Article 28 from the Treaty. Given current U.S. treaty policy, however, this solution is unlikely to be realized. Yet, there are various reasons for a less stringent anti-treaty shopping policy which might finally persuade the United States to redefine its policy.[263]

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[257] *See* EC TREATY art. 177.

[258] *See* EC TREATY art. 169. The discriminatorily treated company itself cannot directly commence proceedings before the Court of Justice. An action of annulment is available but designed to challenge the validity of EU acts, not national acts. EC TREATY art. 173. A complaint about the Council's or Commission's failure to act will also not be successful because the harmonization of direct taxes is not covered by any express obligation of the EC Treaty. EC TREATY art. 175.

[259] *See* U.S.-German Treaty, *supra* note 1, art. 25, ¶ 3249.51.

[260] *See supra* note 166.

[261] *See, e.g.*, Frans Vanistendael, *The Limits to the New Community Tax Order*, 31 COMMON MKT. L. REV. 293, 308 (1994).

[262] *See* EC TREATY art. 5. The Commission is empowered to enforce a Member State's obligation under Article 5 by initiating an action before the Court of Justice against this Member State. EC TREATY arts. 169, 171. *See also* Norbert Dautzenberg, *EG-Vertrag und deutsche Erbschaftssteuer*, 52 BETRIEBS-BERATER 123, 125 (1997).

[263] *See supra* Part II.C.4.a (discussing the arguments for and against treaty shopping prevention).

2. The Implementation of the Derivative Benefits Concept

Modification of Article 28 would reconcile treaty shopping prevention with the freedom of establishment under the EC Treaty.[264] A limitation on benefits clause that maintains an ownership percentage test must fully take into account ownership by EU nationals.[265] This can be best done by adding EU nationality to the ownership percentage test wording[266] so that any EU owner would count for the company's Treaty qualification.[267]

Alternatively, Treaty benefits could be made available to EU companies by implementation of the so-called derivative benefits concept into the U.S.-German Treaty.[268] This concept is based on a teleological view of the treaty network as a whole. Its idea is to allow treaty benefits to the ultimate owner residing in a third country if this third party country also has a treaty that would make the benefits available to that person.[269] No unjustified advantages to the third-country owner are created because benefits would already be available under the treaty of this third party country, and therefore it is assumed that there are appropriate business reasons for establishing a company outside the third party country.

This concept would harmonize a country's treaty network and simplify tax law on an administrative level because it is less complex and more efficient than time-consuming, material tests in traditional limitation on benefits provisions. It does not create a disincentive for third party countries to enter into treaty negotiations because only a narrow class of countries derives their benefits from each other. Each Member State of the European Union already has a treaty with the United States, so nationals of these states could derive their eligibility from these treaties.

However, there are problems inherent in the idea of derivative benefits. Existing treaties grant tax benefits to different extents, so treaty shopping may not be fully abolished by allowing derivative benefits. The contracting states would have to restrict the grant of derivative benefits to the extent that the treaties in question are comparable. This raises the question of how to define the treaties which are eligible for the application of derivative benefits. For example, definitions used so far include the requirement of having "in effect a comprehensive income tax convention"[270] but do not state in detail when a convention becomes comprehensive.

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[264] *See* EC TREATY art. 52.

[265] *See supra* Part II.C.4.b.

[266] *See* U.S.-German Treaty, *supra* note 1, art. 28(1)(e)(aa), ¶ 3249.57.

[267] This has been done with subsequent treaties to a certain extent; however, no treaty goes as far as recognizing a full ownership by any EU national. *See supra* note 53.

[268] *See* Vanistendael, *supra* note 261, at 306-07; M.J. Ellis, *Limitation of Benefits: a Netherlands Perspective*, 17 INTERTAX 344, 348-49 (1989).

[269] *See* Streng, *supra* note 32, at 43-51.

[270] U.S.-Dutch Treaty, *supra* note 52, art. 26, ¶ 6103.28.

Another problem with derivative benefits is that, as with limitation on benefits clauses, derivative benefits clauses can be problematic if they become too complicated, detailed, or abstract. A recent derivative benefits clause, for example, grants derivative benefits only to companies that are not conduit companies.[271] This provision is tautological because the derivative benefits concept is intended to offer a way out of definition problems in limitation on benefits provisions but these problems, in turn, originate from the question of how to identify conduit companies. Derivative benefits also do not guarantee a stable multilateral solution because treaty negotiations would merely continue on a bilateral level. However, multilateral solutions are preferable because bilateral treaties can still break out of the derivative benefits network or be terminated. For this reason, the danger of treating EU nationals differently cannot completely be eliminated by the derivative benefits concept. Host countries to EU-owned companies could grant treaty benefits insofar as EU owners could derive benefits from their home country treaty which would accord them treatment equal to host country nationals. But compared to other EU nationals who cannot derive benefits due to the lack of a treaty with the United States, they would still be given a preferential treatment. So discrimination could still occur between different EU nationals.

To date, the United States has hesitated to adopt the derivative benefits concept in treaties.[272] Due to the growing importance of regional economic integration, however, this attitude appears to be changing. For example, the derivative benefits concept has been used for the recognition of nationals from member states of the North American Free Trade Agreement.[273] The U.S.-Mexican Treaty provides that shareholders are considered for benefits if they reside in a NAFTA country.[274] Regarding the consideration of EU shareholders as treaty beneficiaries, the U.S.-Dutch Treaty is the first treaty that implements a clause with derivative benefits elements,[275] and other treaties have followed.[276] An implementation of the derivative benefits

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[271] *See* U.S.-Dutch Treaty, *supra* note 52, art. 26(1)(c)(iii), ¶ 6103.28.

[272] *See* Cohen, *supra* note 54, at 416-20; Streng, *supra* note 32, at 43.

[273] *See* North American Free Trade Agreement, Dec. 17, 1992, U.S.-Mex.-Can., 32 I.L.M. 289, 605 (entered into force Jan. 1, 1994) [hereinafter NAFTA].

[274] *See* Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 18, 1992, U.S.-Mex., art. 17(1)(d)(iii), *reprinted in* 2 Tax Treaties (CCH) ¶ 5903.19 (1994) [hereinafter U.S.-Mexican Treaty]. *See also* Michele Gelb, *The Limitation on Benefits Provisions of the United States-Mexico Tax Treaty*, 9 EMORY INT'L L. REV. 217 (1995).

[275] *See* U.S.-Dutch Treaty, art. 26, *supra* note 52, ¶ 6103.28. *See also* Sugarman, *supra* note 47, at 815.

[276] For example, the U.S.-Luxembourg, U.S.-French, and U.S.-Spanish Treaties partially implement EU ownership into their limitation on benefit clauses. Convention Between the Government of the Grand Duchy of Luxembourg and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with

concept in the treaties between the United States and European countries appears to ease discrimination but does not completely eliminate it.[277]

B. A Pan-European Renegotiation

Renegotiation is not only necessary for the U.S.-German Treaty but also for any other treaty between a Member State of the European Union and the United States if its limitation on benefits clause conflicts with European Union law. This obligation is found in Article 5 of the EC Treaty.[278] Apart from this, all European treaties with the United States should be renegotiated with the aim of harmonizing these treaties. A pan-European solution to treaty shopping can be reached in various ways.[279] One possibility is to develop uniform treaty shopping rules within the EU by way of EU legislation.[280] More promising, however, is the perspective of establishing one single treaty between the United States and the European Union as a whole.[281] A single treaty, which would replace all existing bilateral treaties, could offer a solution for the problem of treaty shopping that is open to the Member States of the European Union but restrictive against third countries. It could create uniform and modern rules on treaty shopping prevention as well as exchange of information procedures. Adoption of uniform treaty shopping rules would render national treaty

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Respect to Taxes on Income and Capital, Apr. 3, 1996, U.S.-Lux., art. 24, *reprinted in* 2 Tax Treaties (CCH) ¶ 5701.49; U.S.-French Treaty, art. 30, *supra* note 52, ¶ 3001.31; U.S.-Spanish Treaty, art. 17, *supra* note 52, ¶ 8403.45. Interestingly, the U.S.-Swiss Treaty also implements a derivative benefits test covering nationals of the EU, EFTA, and NAFTA members, although Switzerland itself is not a Member State of the European Union. U.S.-Swiss Treaty, art. 22(1), *supra* note 56, at ¶ 9101.22.

[277] *See* Vanistendael, *supra* note 261, at 307-308 (arguing in favor of the derivative benefits concept); Eric M. Overman, *The U.S.-Netherlands Tax Treaty: Important Changes, Practitioners' Response, and Primary Effects*, 48 TAX LAW. 207, 228 (1994) (considering the derivative benefits concept as a "significant liberalization from the approach adopted in the U.S.-German treaty"); H. David Rosenbloom, *Derivative Benefits: Emerging US Treaty Policy*, 22 INTERTAX 83 (1994) (explaining the reluctant and critical U.S. approach to the implementation of the derivative benefits concept).

[278] *See* EC TREATY art. 5.

[279] *See* Tracy A. Kaye, *European Tax Harmonization and the Implications for U.S. Tax Policy*, 19 B.C. INT'L & COMP. L. REV. 109, 168-71 (1996); Marlin Risinger, *U.S. Tax Treaty Policy and the EC Directives on Parent/Subsidiary Distributions and Mergers*, *in* 1992 Proceedings of the 85th Annual Conference on Taxation (Frederick D. Stocker ed. 1993), at 19, 22-23; *see also* Brian J. Arnold & Neil H. Harris, *NAFTA and the Taxation of Corporate Investment: A View from Within NAFTA*, 49 TAX L. REV. 529, 109 (1994) (arguing that there is a similar need for harmonization of bilateral tax treaties between NAFTA members).

[280] *See* Risinger, *supra* note 279, at 23 (regarding uniform treaty shopping rules as a substantial benefit from the U.S. perspective); *but see* Maurice de Kleer, *Towards a European Anti-Abuse Doctrine in Direct Taxation?*, 24 INTERTAX 137, 144 (1996) (arguing that two problems with uniform treaty shopping rules would be finding a common definition of treaty shopping and maintaining the flexibility of those rules).

[281] *See* Risinger, *supra* note 279, at 23.

shopping law useless as far as Member States of the European Union are concerned. It could reconcile European Union law and treaty law, and reduce the administrative time and effort that ongoing bilateral negotiations with many European countries require.[282] With respect to some older U.S. treaties with European countries that lack limitation on benefit clauses,[283] a EU-wide standard of treaty shopping prevention would be more efficient and provide benefits to the United States.[284]

Unfortunately, the idea of a pan-European treaty with the United States is not without its own problems. It is disputed whether the EU still needs to be granted the competence to represent the Member States as a whole in the area of direct taxation.[285] Other treaty parties of the United States might feel excluded from a single treaty. The United States would also lose its bargaining power in view of each single European country. This aspect would be advantageous to the European Union because the current U.S. treaty policy hinders further harmonization within the European Union. A European Union treaty is desirable even if does not seem practical at this moment.[286]

IV. CONCLUSION

The limitation on benefits clause of the U.S.-German Treaty in its current formulation is an unjustified violation of the freedom of establishment mandated by the EC Treaty and is not compatible with European Union law. Comparable clauses in other treaties between the United States and Member States of the European Union are also incompatible with the EU mandate. Remedies for discriminated companies are available but insufficient. Germany is under an obligation to renegotiate the U.S.-German

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[282] *See* Risinger, *supra* note 279, at 23; Kaye, *supra* note 279, at 170.

[283] Existing treaties between the United States and Belgium, Greece, and Ireland have neither limitation on benefits provisions, nor are they about to be replaced by recently signed treaties, which contain those clauses but are still awaiting legislative approval. Convention Between the United States of America and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, July 9, 1970, U.S.-Belg., *reprinted in* 1 Tax Treaties (CCH) ¶ 1303; Convention Between the United States of America and the Kingdom of Greece for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Apr. 20, 1953, U.S.-Greece, *reprinted in* 2 Tax Treaties (CCH) ¶ 3403; Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 13, 1949, U.S.-Ir., *reprinted in* 2 Tax Treaties (CCH) ¶ 4403.

[284] *See* Risinger, *supra* note 279, at 23; Kaye, *supra* note 279, at 170.

[285] *See* Kaye, *supra* note 279, at 170 (arguing that there is no EU competence for a U.S.-EU treaty). *But see* Hinnekens, *supra* note 50, at 156 (finding the external tax competence of the EU in Article 235 of the EC Treaty which grants powers to the EU to the extent necessary to attain its objectives).

[286] *See* Becker & Thömmes, *supra* note 156, at 568; Haug, *supra* note 32, at 286-89; van Unnik & Boudesteijn, *supra* note 54 , at 115; Risinger, *supra* note 279, at 23; Risinger, *supra* note 279, at 23; Kaye, *supra* note 279, at 169.

Treaty, and should at least insist on the implementation of the derivative benefits concept into the Treaty, provided that the United States is willing to alter or redefine its treaty policy. However, a desirable solution to the problem of treaty shopping can only be found in a single treaty, yet to be negotiated, between the European Union and the United States.