Dick A. Hofland*
and Prof. Dr Frank P.G. Pötgens**

The LOB Provision in the New Japan–Netherlands Tax Treaty

Ambiguities and Incompatibilities with EU Law Prompted the Netherlands to Reconsider the LOB Provision

In this note, the authors review the compatibility of the limitation on benefits provision of the Japan–Netherlands tax treaty with the OECD Model Tax Convention and the non-discrimination provisions and fundamental freedoms of the Treaty on the Functioning of the European Union, and conclude that it is clearly in conflict with a number of essential EU law provisions.

1. Introduction

On 25 August 2010, the Netherlands and Japan concluded a tax treaty (the "Treaty") that will replace the current Japan–Netherlands tax treaty (1970). The most remarkable provision in the Treaty is Art. 21, the limitation on benefits provision ("LOB Provision"). This is only the second LOB provision that the Netherlands has included in its tax treaties, the other being Art. 26 of the Netherlands–United States tax treaty (1992).[1] The LOB Provision is, by definition, controversial because it denies protection to a wide range of Dutch taxpayers.

In this note, the authors discuss the LOB Provision (section 3.) by reference to an example (section 2.). The authors examine whether or not that provision is compatible with (1) the OECD Model Tax Convention (OECD Model) and its Commentaries and (2) EU law (section 3.). Section 4. provides a conclusion and a summary.

2. Example Used to Illustrate the Effects of the LOB Provision

Where appropriate, the different elements of the LOB Provision[2] are illustrated on the basis of the following example.

Example

BV X is a company incorporated according to Dutch law having its place of effective management in the Netherlands. BV X conducts an active business. BV X holds a participation, i.e. 60% of the preferred shares, in Z KK (*Kabushi Kaisha*), a company incorporated according to Japanese law with its place of effective management in Japan. BV X's participation in Z KK forms part of the active business conducted by BV X. 100% of the ordinary shares in BV X is held by Y GmbH. Y GmbH is incorporated according to German law. The effective management of Y GmbH is located in Germany. BV X, Y GmbH and Z KK are all limited liability companies.

3. The LOB Provision (Art. 21 of the Treaty)

3.1. Scope

The scope of the LOB provision (Art. 21(1) of the Treaty) is limited in the sense that it only has repercussions for Art. 10(3) of the Treaty (no taxation on dividends in the source state), Art. 11(3) of the Treaty (no taxation on interest in the source state), Art. 12 of the Treaty (royalties),[3] Art. 13 of the Treaty (capital gains) and Art. 20 of the Treaty (other income).

3.2. Qualified persons

According to Para. 2 of the LOB Provision, a qualified person is (1) an individual; (2) the government of either contracting state or any political subdivision or local authority thereof, etc.; (3) companies meeting the stock exchange test (see 3.3.); (4) certain pension funds (see 3.4.) and persons established for charitable purposes; (5) banks, an insurance company or a securities company; and (6) a person other than an individual, if a resident of either contracting state and a qualified person by reason of (1), (2), (3) or (4) owns, directly or indirectly, shares or other beneficial interests representing at least 50% of the voting power of that person.

3.3. Art. 21(2)(c) of the Treaty (stock exchange test)

Art. 21(2)(C) provides that a company is a qualified person only if it meets the stock exchange test, i.e. it must be:

* Tax lawyer at De Brauw Blackstone Westbroek N.V. in Amsterdam. The author can be contacted at dick.hofland@debrauw.com.

** Professor of International and European Tax Law, VU University Amsterdam and tax lawyer at De Brauw Blackstone Westbroek N.V. in Amsterdam. The author can be contacted at frank.potgens@debrauw.com or f.p.g.potgens@vu.nl.

1. In December 2010 the new Netherlands–Panama tax treaty was published, containing an LOB type provision in Art. 10 (dividends).
2. The OECD, in a 1992 recommendation accompanying the Commentary on the OECD Model, indicated that a tax treaty does not exclusively address the elimination of double taxation but also deals with the prevention of tax evasion; see also, M.H.J. Haarsma, R. Post and R.G. Prokisch, "Het Nederlandse verdragsbeleid: verleden en toekomst (deel 1)", *Forfaitair* 2010/205, section 4. As a result, the Treaty, as indicated in its heading, also encompasses "the prevention of tax evasion". Since 2003, Para. 7 of the Commentary on Art. 1 of the OECD Model has provided that, "[i]t is also a purpose of tax conventions to prevent tax avoidance and tax evasion". An LOB provision could fall within the scope of such a purpose.
3. According to Art. 12(1) of the Treaty, royalties are taxable exclusively in the residence state.

> [...] a company, if the principal class of its shares is listed or registered on a recognized stock exchange and is regularly traded on one or more recognized stock exchanges, provided that, if the shares are listed or registered on a recognized stock exchange specified in clause (iii) or (iv) of subparagraph c of paragraph 8, the primary place of management and control of the company is in the Contracting State of which it is a resident.

Art. 21(8)(c)(iii) specifies a number of recognized stock exchanges (inter alia, a number of EU stock exchanges) whereas Art. 21(8)(c)(iv) allows for the competent authorities to agree to recognize any other stock exchange for the purposes of the LOB Provision.

3.4. Art. 21(2)(d) of the Treaty (pension funds)

Pursuant to Art. 4(1)(b), a pension fund is a resident for Treaty purposes. Moreover, the pension fund should be a qualified person as defined in Art. 21(2)(d) in order to be entitled to Treaty benefits. The requirements of Art. 21(2)(d) are met if: (1) more than 50% of the pension fund's beneficiaries, members or participants are individuals who are residents of either Japan or the Netherlands, or (2) more than 75% of the contributions made to the pension fund are derived from residents of either Japan or the Netherlands that are also qualified persons.

3.5. Art. 21(3) of the Treaty (derivative benefits test)

Notwithstanding that a company that is a resident of either contracting state may not be a qualified person, that company shall be entitled to certain Treaty benefits if shares representing at least 75% of the voting power of that company are owned, directly or indirectly, by seven or fewer persons who are "equivalent beneficiaries". According to Art. 21(8) (d), the term equivalent beneficiary means, in short, (1) a resident of a third state that has concluded a tax treaty with a contracting state (the Netherlands or Japan) on the basis of which the benefits of the Treaty are claimed, and (2) that resident would be entitled under the tax treaty between his residence state and either Japan or the Netherlands ("Third State treaty") to similar benefits with respect to an item of income referred to in Art. 10(3) of the Treaty (no taxation on dividends in the source state), Art. 11(3) of the Treaty (no taxation on interest), Art. 12 of the Treaty (royalties), Art. 13 of the Treaty (capital gains) or Art. 20 of the Treaty (other income), as are being claimed under the Treaty.

3.6. Art. 21(5) of the Treaty (active trade or business test)

If a resident of either contracting state is not a qualified person that resident shall still be entitled to treaty benefits if he is carrying on business in either contracting state and the item of income for which Treaty benefits are claimed is derived in connection with, or is incidental to, that business. However, Art. 21(5)(a)(i) excludes from a qualifying activity, "the business of making or managing investments for the resident's own account, unless the business is banking, insurance or securities business carried on by a bank, insurance company or securities company". The question arises as to how this exclusion would relate to Para. 6.8 et seq. of the 2010 Commentary on Art. 1 of the OECD Model if the Dutch company in the Example were characterized as a Collective Investment Vehicle (CIV).[4] The OECD Commentary seeks to grant treaty benefits to entities qualifying as CIVs and to treat these CIVs as beneficial owners.[5] However, they are denied the Treaty benefits as a result of the exclusion in Art. 21(5)(a)(i).[6] Japan and the Netherlands were both involved in the drafting process of the respective reports[7] that resulted in the insertion of the key results into the 2010 Commentary on the OECD Model in connection and neither of these states made any observation on these provisions of the Commentary.

3.7. Art. 21(6) of the Treaty (headquarters company test)

Art. 21(6)(b)(iii) and (iv) sets out the specific requirements for the Headquarters Company Test. A resident of a contracting state functions as a headquarters company for a multinational corporate group if the business carried on in any one country, other than that contracting state, generates less than 50% of the gross income of the group and no more than 50% of its gross income is derived from the other contracting state. Some of the criteria that must be satisfied to be regarded as a headquarters company are rigid, for example, Art. 21(6)(b)(ii) states that the group must consist of companies that are resident in, and are carrying on business in, at least five countries, and the business carried on in each of the five countries must generate at least 5% of the gross income of the group. The Netherlands–US tax treaty (1992) contains a comparable provision (Art. 26(3)). However, it appears that there are few or no cases where Dutch resident companies have been allowed to claim tax treaty benefits pursuant to that test even where they, in fact, exercised headquarters company functions.

3.8. Art. 21(7) of the Treaty (saving clause)

Art. 21(7) contains a saving clause permitting the competent authorities to grant the Treaty benefits to a company even if it is not a qualified person.

4. These paragraphs were inserted into the Commentary in 2010 as a consequence of the OECD Report entitled, "The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles", 23 April 2010. For a discussion of this report, the authors refer to E. Barret, "Aspects of the 2010 Update Other than Those Relating to Article 7 of the OECD Model Tax Convention", *Bulletin for International Taxation* 1 (2011), p. 13 et seq. and G.K. Fibbe, "Changes to the OECD Commentary on Collective Investment Vehicles Proposed by the OECD Committee on Fiscal Affairs" *Bulletin for International Taxation* 3 (2010), p. 138 et seq.
5. Para. 6.14 of the 2010 Commentary on Art. 1 of the OECD Model.
6. States not treating a CIV as a person that is also a resident, for example, because the CIV is subjectively exempt, or as the beneficial owner, could consider expressly providing for the treaty entitlement of CIVs by including a specific provision in their respective tax treaties; see Para. 6.17 et seq. of the 2010 Commentary on Art. 1 of the OECD Model.
7. Representatives of both the Dutch and the Japanese Ministry of Finance participated in, "The Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors" (the "ICG"; representatives of the financial industry also participated in this group) that was established in 2006 by the Committee on Fiscal Affairs as a result of a Round Table organized by the OECD on 1 and 2 February 2006 in Paris. Under the chairmanship of the American, Patricia Brown, several reports and discussion drafts of the ICG were published, available at www.oecd.org.

4. EU Law

4.1. In general

In this section, the authors first examine whether or not the LOB Provision infringes the freedom of establishment in Art. 49 of the Treaty on the Functioning of the European Union (TFEU) since the LOB Provision regularly refers to a minimum of 50% of the voting power.[8] Where appropriate, the LOB Provision is also examined in light of the free movement of capital (Art. 63 TFEU), the freedom to provide services (Art. 56 TFEU) and the free movement of workers (Art. 45 TFEU).[9]

As regards the compatibility of the LOB Provision with EU law (i.e. the non-discrimination principle included in the TFEU) a number of principles should be taken into account.[10] The decisions of the European Court of Justice (ECJ) in *Gilly*,[11] *D*,[12] *ACT Group Litigation*[13] and *Columbus Container*[14] demonstrate that the Member States have a certain degree of sovereignty when concluding tax treaties and allocating taxing jurisdiction.[15] These decisions of the ECJ involved tax treaties between Member States of the European Union.

However, even if a Member State, such as the Netherlands, concludes a tax treaty with a Non-Member State, like Japan, that treaty must comply with the non-discrimination principles included in the TFEU. The ECJ, in the *Open Skies* decisions,[16] held that the freedom of establishment (Art. 49 TFEU) precludes Member States from concluding treaties with Non-Member States if no account is taken of certain aspects of EU law. Applying that rule to the LOB Provision implies that companies residing in the Netherlands cannot be excluded from treaty benefits with respect to income and capital gains of Japanese origin because they are wholly or partly owned by residents of other Member States.[17] As a contracting state, the Netherlands should prevent the various tests laid down in the LOB Provision from being at variance with EU Law, in particular, with the freedom of establishment, otherwise the Netherlands will be liable for compensation to the Dutch company being discriminated against or impeded because it is wholly or partly owned by residents of other Member States.[18] However, all of the conditions set out in the decisions of the ECJ must be satisfied.[19]

The aforementioned conclusion is not prejudiced by the ECJ's decision in *ACT Group Litigation*.[20] The decision in that case was made on the basis of most-favoured-nation treatment (see also the *D* case mentioned above)[21] and

8. See also the decision in ECJ, 13 April 2000, Case C-251/98, *C. Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*. Art. 49 of the TFEU applies if the holding in the capital of a company confers on the shareholder such influence over the company's decisions that he can determine its activities.
9. Compare also E. Osterweil, "Are LOB Provisions in Double Tax Conventions Contrary to EC Treaty Freedoms?", *EC Tax Review* 5 (2009), pp. 240 and 241.
10. It is useful to note that EU law prevails not only over Dutch domestic law but also over tax treaties concluded by the Netherlands. Compare also the decisions in ECJ, 27 September 1988, Case 235/87, *Annunziata Matteucci v. Communauté française of Belgium and Commissariat général aux relations internationales of the Communauté française of Belgium*; ECJ, 22 September 1988, Case 286/86, *Ministère public v. Gérard Deserbais*; and ECJ, 19 January 2006, Case C-265/04, *Margaretha Bouanich v. Skatteverket*. See also M. Helminen, *EU Tax Law – Direct Taxation* (Amsterdam: IBFD, 2009), p. 24. The Netherlands is not allowed to conclude tax treaties or apply existing tax treaties if they are incompatible with EU law; compare the decision in ECJ, 28 January 1986, Case 270/83, *European Commission v. French Republic (Avoir Fiscal)*. The same applies to tax treaties the Netherlands concludes or has concluded with a third state. The aforementioned similarly follows from the loyalty principle (Art. 4 of the Treaty on European Union, TEU); see also Helminen, note 10, p. 28 and E.C.C.M. Kemmeren, "Limitation-on-benefits in het belastingverdrag Nederland-VS 2005 en het EG-recht: het dienen van twee heren", in R.G.J. Lauwerier, L.B.T. Pakos, A.M.J. van den Biggelaar, P.E.F. Domevscek, A. Stoop and A.G.E. Verbart (eds.), *Festschrift JUVAT 2005* (Nijmegen: Wolf Legal Publishers, 2006), pp. 38-39.
11. ECJ, 12 May 1998, Case C-336/96, *Gilly v. Directeur des services fiscaux du Bas-Rhin*.
12. ECJ, 5 July 2005, Case C-376/03, *D. v. Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen*.
13. ECJ, 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*.
14. ECJ, 6 December 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt*.
15. According to *Columbus Container* (see note 14); ECJ, 20 May 2008, Case C-194/06, *Staatssecretaris van Financiën v. Orange European Smallcap Fund NV*; and ECJ, 12 February 2009, Case C-67/08, *Margarete Block v. Finanzamt Kaufbeuren*., the freedom of establishment and the free movement of capital cannot be understood such that a Member State, under the current stage of the development of EU law, is obliged to adapt its own tax systems to the different systems of tax of the other Member States in order, inter alia, to eliminate the double taxation arising from the exercise in parallel by those Member States of their fiscal sovereignty.
16. Compare ECJ, 5 November 2002, Cases C-466/98, C-467/98, C-468/98, C-471/98, C-472/98, C-475/98, C-476/98, *Commission of the European Communities v. United Kingdom of Great Britain and Northern Ireland, Commission of the European Communities v. Kingdom of Denmark, Commission of the European Communities v. Kingdom of Sweden, Commission of the European Communities v. Kingdom of Belgium, Commission of the European Communities v. Grand Duchy of Luxembourg, Commission of the European Communities v. Republic of Austria, Commission of the European Communities v. Federal Republic of Germany*, but also ECJ, 14 October 2004, Case C-299/02, *Commission of the European Communities v. Kingdom of the Netherlands* and ECJ, 24 April 2007, Case C-523/04, *Commission of the European Communities v. Kingdom of the Netherlands (Open Skies)*. For a discussion of these cases, the authors refer to H.T.P.M. van den Hurk, "De bevoegdheid van lidstaten om belastingverdragen te sluiten aan de ketting?", 72 *Maandblad Belastingbeschouwingen* 5 (2003), p. 155 et seq.
17. Compare also ECJ, 15 January 2002, Case C-55/00, *Elide Gottardo v. Istituto nazionale della previdenza sociale (INPS)*; ECJ, 27 September 1988, Case 235/87, *Annunziata Matteucci v. Communauté française of Belgium and Commissariat général aux relations internationales of the Communauté française of Belgium*, and ECJ, 21 September 1999, Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*. To the same effect, see B.J.M. Terra and P.J. Wattel, "European Tax Law", in *Fiscale Handboeken* (Deventer: Kluwer, 2008), p. 775; F.A. Vega Borrega, "Limitation on Benefits Clauses in Double Taxation Conventions", *Eucotax Series on European Taxation*, Volume 12 (London: Kluwer Law International, 2006), p. 245 and J.C. Guerra, "Limitation on Benefits Clauses and EU Law", *European Taxation* 2/3 (2011), pp. 86 and 87.
18. The authors assume that the LOB Provision cannot be held to be void on the basis of Art. 46 of the Vienna Convention on the Law of Treaties; compare, as regards the Netherlands–United States tax treaty, Kemmeren, note 10, p. 74.
19. See ECJ, 19 November 1991, Joined Cases C-6/90 and C-9/90, *Andrea Francovich and Danila Bonifaci and others v. Italian Republic* and ECJ, 5 March 1996, Case C-46/93, *Brasserie du Pêcheur SA v. Bundesrepublik Deutschland and The Queen v. Secretary of State for Transport, ex parte: Factortame Ltd and others*. See also, although in a slightly different context, ECJ, 17 October 1996, Case C-283/94, *Denkavit Internationaal BV, VITIC Amsterdam BV and Voormeer BV v. Bundesamt für Finanzen*.
20. See ECJ, 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*.
21. To the same effect see L. De Broe, "International Tax Planning and the Prevention of Abuse", Doctoral Series, No. 14 (Amsterdam: IBFD, 2008), p. 1052 et seq. and E.C.C.M. Kemmeren, "LOB ≠ MFN", in D.A. Albregtse and P. Kavelaars (eds.), *Maatschappelijk heffen*, Volume 1 (Deventer: Kluwer, 2006), p. 417 et seq. (further to ECJ, Advocate General Geelhoed's Opinion, 23 February 2006, Case C374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*). The authors assume that P.J. Wattel reached a similar conclusion since he explicitly interprets the decision against the background of most-favoured-nation treatment

not, as in the *Open Skies* decisions, on the basis of the freedom of establishment (or a restriction of such freedom). In the *D* and *ACT Group Litigation* cases the ECJ rejected the theory that the TFEU requires the granting of most-favoured-nation treatment. However, the *Open Skies* decisions did not involve a claim regarding most-favoured-nation treatment. In the *Open Skies* decisions, the ECJ ruled that a company was being treated differently based on its place of residence (nationality) of its shareholders; as a result, this could trigger (1) liability on behalf of the Netherlands for compensation,[22] (2) infringement proceedings,[23] or (3) if relevant, and to the extent possible, (broader) application of the methods for the elimination of double taxation by the Netherlands.[24] Further, an LOB provision does not pertain to the allocation of taxing jurisdiction – Arts. 10, 11, 12, 13 and 20 address the division of taxation rights – but constitutes one of the other provisions of a tax treaty that should be in line with the non-discrimination principles laid down in the TFEU.[25]

In order to invoke Art. 49 of the TFEU there must be an actual establishment in another Member State intended to carry on genuine economic activities for an indefinite period.[26] If such an establishment is present and there is a restriction on the freedom of establishment or discrimination – which is the case in the Example because the Dutch company would have been a qualified person had its shares been owned by shareholders residing in the Netherlands – it should be examined in each particular case[27] whether the prevention of abuse can serve as a justification for this restriction or discrimination.[28] The ECJ, in its *Cadbury Schweppes* decision,[29] ruled that the prevention of abuse may be accepted as a ground of justification where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned with a view to escaping the tax normally due. Furthermore, the *Cadbury Schweppes* decision demonstrates that the subjective element of the taxpayer alone, consisting of an intention to obtain a tax advantage, is not decisive in this respect. Whether a wholly artificial arrangement is present must be determined on the basis of objective factors that are ascertainable by third parties, such as premises, staff and equipment.[30]

Preventing abuse is an accepted reason in the public interest, which can serve as a justification ground. Furthermore, the application of an LOB provision would be appropriate to ensure the attainment of the objective, i.e. preventing tax avoidance or evasion. Consequently, the LOB Provision satisfies this appropriateness test. However, in the authors' opinion, the LOB Provision will not meet the proportionality test[31] in all cases since, in certain cases, it will also be applicable to situations in which not a wholly artificial arrangement but the actual pursuit of an economic activity is present.[32]

The authors' position that the proportionality test is not satisfied is also supported by the argument that Para. 7 et seq. of the 2010 Commentary on Art. 1 of the OECD Model demonstrate that other and more proportionate alternatives are conceivable.[33] These alternatives provide

in the treaty context (see Para. 15 of his Opinion in *ACT Group Litigation*, BNB 2007/131, and Terra and Wattel, note 17, p. 776). Compare also A.C.G.A.C. de Graaf, "Designing an anti-treaty shopping provision: an alternative approach", *EC Tax Review* 2 (2008), pp. 12 and 13 and Guerra, note 17, pp. 86-87.

22. See Borrego, note 17, pp. 265-273; Osterweil, note 9, pp. 243-245; and Guerra, note 17, p. 95.
23. The Commission could initiate infringement proceedings (Art. 258 TEU) against the Netherlands demanding that it renegotiate the Treaty in order to eliminate its incompatibility with the non-discrimination provisions of the TFEU.
24. Kemmeren, note 10, p. 73.
25. De Broe, note 21, p. 1049. An LOB provision operates at a later stage than the tax treaty provisions allocating taxation rights. An LOB provision concerns the exercise by the source state of its taxing powers and its aim not to make concessions regarding these rights if the treaty benefits are ultimately obtained by a resident of a third state. This conclusion is relevant because the ECJ ruled in ECJ, 21 September 1999, Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*; ECJ, 12 December 2002, Case C-385/00, *F. W.L. de Groot v. Staatssecretaris van Financiën*; *Bouanich*, see note 10; and ECJ, 14 December 2006, Case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, that, although Member States are at liberty, within the framework of tax treaties, to determine the connecting factors for the purpose of allocating taxation powers as between themselves, they may nevertheless not disregard EU law when exercising those powers (see, for example, *Saint Gobain*, Paras. 56 and 57). Compare also A. Zester, "Can the MFN Principle Influence the Use of Limitation on Benefits Clauses in Tax Treaties?", *Intertax* 3 (2006), pp. 144 and 149; P. Pistone, "Test Claimants in Class IV of the ACT Group Litigation: Limitation-Of-Benefits Clauses Are Clearly Different from Most-Favoured-Nation Clauses", *British Tax Review* 4 (2007), p. 364 and Guerra, note 17, pp. 88 and 89.
26. See ECJ, 25 July 1991, Case C-221/89, *The Queen v. Secretary of State for Transport, ex parte Factortame Ltd and others*. It follows from the decision of the ECJ in ECJ, 13 April 2000, Case C-176/96, *Jyri Lehtonen and Castors Canada Dry Namur-Braine ASBL v. Fédération Royale Belge des Sociétés de Basket-ball ASBL (FRBSB)* that the term "economic activity" should not be interpreted narrowly. Furthermore, the decisions in ECJ, 10 July 1986, Case 79/85, *D. H. M. Segers v. Bestuur van de Bedrijfsvereniging voor Banken Verzekeringswezen, Groothandel en Vrije Beroepen* and ECJ, 9 March 1999, Case C-212/97, *Centros Ltd v. Erhvervs- og Selskabsstyrelsen* demonstrate that the ECJ interprets the economic activity requirement rather flexibly; to the same effect, see Advocate General Wattel's Opinion of 14 July 2004 accompanying the decision of the Dutch Supreme Court (*Hoge Raad*), 13 May 2005, BNB 2005/234, Para. 6.4. In Para. 6.7. he outlines that, although Centros Ltd had not yet pursued an economic activity, it had the right to invoke the freedom of establishment.
27. See the decisions of the ECJ in ECJ, 17 July 1997, Case C-28/95, *A. Leur-Bloem v. Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2* and 28 October 2010, Case C-72/09, *Société Etablissements Rimbaud v. Direction Générale des Impôts* (in Para. 34 the ECJ holds that "a general presumption of tax avoidance or evasion is insufficient to justify a tax measure which adversely affects the objectives of the [TFEU]"). Therefore, one should be reluctant with respect to anti-abuse measures having a general scope.
28. The decision in ECJ, 17 September 2009, Case C-182/08, *Glaxo Wellcome GmbH & Co. KG v. Finanzamt München* and, following therefrom, the text of the LOB Provision and its presumed intention demonstrate that it is aimed at discouraging certain types of abuse; compare also Kemmeren, note 10, pp. 43 and 50; S. van Weeghel, "Improper Use of Tax Treaties", *Series on International Taxation*, No. 19 (The Hague: Kluwer Law International, 1998), pp. 212-216 and Guerra, note 17, p. 85.
29. ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*.
30. *Cadbury Schweppes*, see note 29, Para. 67. A wholly artificial arrangement could be, for example, a "letterbox" or "front" subsidiary.
31. See, in the same sense, the decision in ECJ, 21 January 2010, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*.
32. According to the authors, other possible grounds of justification, such as fiscal coherence, the balanced allocation of taxing power and fiscal territoriality, also do not justify the discrimination and the restriction on the freedom of establishment, as well as other freedoms that may apply.
33. De Broe, note 21, pp. 1046 and 1047. Para. 12 of the 2003-2010 Commentary on Art. 1 of the OECD Model already noted that treaty negotiators should take the following into account: specific treaty provisions may be needed in order to address specific forms of abuse, (2) the degree to which tax advantages may actually be obtained through a particular avoidance strategy, (3) the legal context in both contracting states and the extent to which domestic law already responds to this avoidance strategy and (4) the extent to which bona fide economic activities might be unintentionally

ample opportunity to give the LOB Provision an EU dimension. In the authors' opinion, a Dutch company that actually pursues a qualifying economic activity should not be excluded from treaty benefits on the basis that it does not have sufficient qualifying shareholders or that the business it carries on does not qualify under the active trade or business test, for example, "the business of making and managing investments".[34] The following clarifies this conclusion in respect of each test.[35]

4.2. Art. 21(2)(d) of the Treaty (pension funds)

The requirements under Art. 21(2)(d)(i)(aa) (more than 50% of the pension fund's beneficiaries, members or participants are individuals who are resident in either Japan or the Netherlands) and Art. 21(2)(d)(i)(bb) (more than 75% of the contributions made are derived from residents of either Japan or the Netherlands, which residents are qualified persons) cannot be imposed since they are discriminatory and constitute a restriction of the freedom of establishment (Art. 49 TFEU); the treatment of a pension fund depends on the residency (nationality) of its beneficiaries, members or participants, or those who make a contribution.[36]

4.3. Art. 21(2)(b) of the Treaty (stock exchange test)

A number of EU stock exchanges are not mentioned in Art. 21(8)(c) of the Treaty, such as the exchanges in Budapest (BUX), Prague (PX), Warsaw (WIG20) and Athens (ATHEX). This exclusion constitutes a restriction of the freedom to provide services (Art. 56 TFEU) or the free movement of capital (Art. 63 TFEU) for if the principal class of shares in a company is listed and regularly traded on one of these stock exchanges, that company is treated less favourably. This makes it more difficult to attract the trading of shares in companies that would be eligible and are resident in the Netherlands.[37] Furthermore, all companies incorporated according to Dutch law are precluded from being listed on the aforementioned stock exchanges.[38]

Art. 21(8)(c)(iv) of the Treaty allows for the possibility for the competent authorities to mutually agree that a stock exchange qualifies for the purposes of the stock exchange test. However, such a mutual agreement procedure offers insufficient guarantees to remove the objectives from an EU perspective.[39]

4.4. Art. 21(3) of the Treaty (derivative benefits test)

Unlike the Netherlands–US Tax Treaty (1992), the Treaty does not reflect a general EU dimension. There is only a derivative benefits test, a crucial element of which is that the shareholder must have been able to claim equivalent benefits under its "own tax treaty". *Mutatis mutandis*, as argued in 4.2., this also applies here.

In the Example, the German company (Y GmbH) does not qualify as an equivalent beneficiary as defined in Art. 21(8)(d). The reason for this is that the Germany–Japan Tax Treaty (1966) allows for a reduced 10% tax rate on dividends, whereas Art. 10(3) of the Treaty provides for a full exemption. Y GmbH also does not meet the requirements as set out in Art. 21(2)(a), (b), (c) or (d) of the LOB Provision to which Art. 21(8)(d)(ii) refers. As a result, BV X, in the Example, cannot claim any Treaty benefits with respect to dividends received from Japan (from Z KK) because its shareholder is not an equivalent beneficiary. The latter would be the case if, instead of Y GmbH, a Dutch company was Z KK's shareholder because that Dutch company would be an equivalent beneficiary on the basis of Art. 21(8)(d)(i). Pursuant to the decisions of the ECJ referred to in Section 4.1., it should then be determined whether or not there is discrimination or a restriction on the freedom of establishment (Art. 49 TFEU), for which there is no justification.

4.5. Art. 21(5) of the Treaty (active trade or business test)

The exclusion of a "business of making or managing investments for the resident's own account" is evidently not compatible with the freedom of establishment (Art. 49 of the TFEU; an objective justification is, in this scenario,

disqualified by such provisions. Subsequently, the Commentary to the OECD Model describes a number of approaches: (1) the "look through" approach (Paras. 13 and 14 of the 2003-2010 Commentary on Art. 1 of the OECD Model, (2) the "subject to tax" approach (Paras. 15 and 16 of the 2003-2010 Commentary on Art. 1 of the OECD Model), (3) the "channelling" approach (Paras. 17 and 18 of 2003-2010 Commentary on Art. 1 of the OECD Model) and (4) the "exclusion" approach (Paras. 21-21.2 of the 2003-2010 Commentary on Art. 1 of the OECD Model). Because of the general character of these approaches, Para. 19 of the 1992-2010 Commentary on Art. 1 of the OECD Model proposes bona fide (safe harbour) provisions that aim to ensure that treaty benefits are granted in bona fide situations, inter alia, a stock exchange test and a business test, although from the latter the "business of making and managing investments" is not excluded. Para. 20 of the 1995-2010 Commentary on Art. 1 of the OECD Model contains a comprehensive LOB provision (in conformity with Art. 22 of the 2006 US Model Income Tax Convention) to which the Commentary adds that adaptations may be necessary and that many states may reject the insertion of such a provision.

34. In the authors' opinion, this does not prejudice the fact that the comprehensive LOB provision proposed in Para. 20 of the 1995-2010 Commentary on Art. 1 of the OECD Model also excludes the business of making and managing investments from the active trade or business test (Para. 3a of the provision proposed in Art. 20 of the 1995-2010 Commentary on Art. 1 of the OECD Model).
35. For an effort to design a treaty provision that seeks to prevent conduit companies from being set up for treaty shopping purposes with respect to dividends that is acceptable from an EU law point of view, see M. Evers and A.C.G.A.C. de Graaf, "Bestrijding van dividenddoorstroomconstructies: fiscale autonomie van de lidstaten", 79 *Maandblad Belastingbeschouwingen* 10 (2010), p. 347 et seq.
36. The freedom to provide services (Art. 56 TFEU) may play a role in this respect (see ECJ, 26 June 2003, Case C-422/01, *Försäkringsaktiebolaget Skandia (publ) and Ola Ramstedt v. Riksskatteverket*), because the pension fund can only sell pension insurance to a limited extent outside the Netherlands and Japan. The free movement of capital (Art. 63 TFEU) can also come into play because the pension fund may be prejudiced in terms of its investment options if it is not considered a qualified person. The free movement of workers (Art. 45 TFEU) may also be breached in regard to workers residing not in the Netherlands but in the European Union (compare also Kemmeren, note 10, p. 59).
37. Compare E.C.C.M. Kemmeren, "The Netherlands", in G.J.M. de Bont, P.H.J. Essers and E.C.C.M. Kemmeren (eds.), *The compatibility of anti-abuse provisions in tax treaties with EC law*, Eucotax Series on European Taxation, Volume 1 (The Hague: Kluwer Law International, 1989), pp. 137-138; De Graaf, note 21, p. 15; Borrega, note 17, p. 243; Guerra, note 17, p. 90 and M.J. Ellis, "Het Nederlandse Standaardverdrag", 57 *Maandblad Belastingbeschouwingen* 3 (1988), p. 466.
38. Kemmeren, note 10, p. 55.
39. See ECJ, 18 March 2010, Case C-440/08, *F. Gielen v. Staatssecretaris van Financiën*; ECJ, 8 May 1990, Case C-175/88, *Klaus Biehl v. Administration des Contributions du Grand-Duché de Luxembourg* and ECJ, 14 February 1995, Case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker.*

not available)[40] since such activity will generally qualify as a permanent economic activity.[41] In the authors' opinion, this follows from the ECJ decision in *Factortame II*, which is referred to in 4.1.[42]

4.6. Art. 21(6) of the Treaty (headquarters company test)

The strict and specific character of the headquarters company test may be at variance with the freedom of establishment (Art. 49 TFEU); for example, under the five-country requirement (Art. 21(6)(b)(ii)), why is four not sufficient? Further, under the gross income percentage (Art. 21(6)(b)(iii) and (iv)), why is 49% not sufficient?[43] Viewed in this light, discrimination against or a restriction on the freedom of establishment could be present for a company that meets the contours the authors outlined in 4.1. but does not meet the specific requirements of the headquarters company test.

4.7. Art. 21(7) of the Treaty (saving clause)

The possibility of a saving clause is not sufficient to remove the aforementioned EU law compatibility issues, as such a clause depends on the discretion of the competent authorities, who decide on a case-by-case basis.[44]

5. Conclusions

In this note, the authors have cast a critical eye on the LOB Provision. They have identified the following elements of the LOB Provision that are not compatible with the non-discrimination principles in the TFEU:

(1) definition of pension funds in Art. 21(2)(d);
(2) stock exchange test, as set out in Art. 21(2)(b), in particular, the definition in Art. 21(8)(c)(iii), i.e. the exclusion of certain EU stock exchanges;
(3) an overly narrow definition of equivalent beneficiaries in Art. 21(8)(d) that does not sufficiently neutralize the EU law objectives since it may exclude Dutch resident companies from certain treaty benefits because they are held by a shareholder residing in another Member State not qualifying as an equivalent beneficiary;
(4) exclusion of the "business of making or managing investments" from the active trade or business test of Para. 5; and
(5) overly strict conditions that must be met in order to satisfy the headquarters company test as set out in Para. 6.

Of course, contracting states are at liberty to adopt legislation for the prevention of avoidance or evasion, such as an LOB provision. However, such provision must be compatible with the non-discrimination principles of the TFEU as interpreted by the ECJ in its decisions. For that reason, the authors cannot grasp why, in 2010, a Member State concluded a tax treaty including an LOB provision that is clearly in conflict with a number of essential EU law provisions.

With respect to the Treaty's relation to the Commentary on the OECD Model, the question arises why the Netherlands did not ensure entitlement to treaty benefits for CIVs. Given the Dutch authorities involvement in the process ultimately leading to the insertion of the relevant Commentary on the OECD Model and its unconditional support for that Commentary, this is beyond the authors' comprehension.

40. The same conclusion was drawn by Kemmeren, note 21, p. 429 and note 10, p. 67, as well as Borrego, note 17, p. 254.
41. Illustrative are the decisions in ECJ, 14 September 2006, Case C-386/04, *Centro de Musicologia Walter Stauffer v. Finanzamt München für Körperschaften* and ECJ, 11 October 2007, Case C-451/05, *Européenne et Luxembourgeoise d'investissements SA v. Directeur général des Impôts, Direction des services généraux et de l'informatique and Ministère public*, in which the ECJ ruled that the property should be actively managed in order to carry out an economic activity. In this context, the distinction between an involved and a non-involved holding company may be relevant. This distinction is made by the ECJ based on the interpretation of the term "economic activity" as defined in Art. 9(1) of the VAT Directive (Council Directive of 28 November 2006, PbEU L 347 (rectification PbEU L 335) on the common system of value added tax); see the decisions in ECJ, 20 June 1991, Case C-60/90, *Polysar Investments Netherlands BV v. Inspecteur der Invoerrechten en Accijnzen*; ECJ, 14 November 2000, Case C-142/99, *Floridienne S.A. and Berginvest S.A. v. the Belgian State*; and ECJ, 27 September 2001, Case C-16/00, *Cibo Participations S.A. v. Directeur Régional des Impôts du Nord-Pas-de-Calais* and E.C.C.M. Kemmeren, "EC Law: Specific Observations", in Bont et al. (eds.), note 37, pp. 34-35 and Borrega, note 17, p. 253.
42. To the same effect, see De Broe, note 21, pp. 1044-1045.
43. Compare also Kemmeren, note 21, p. 144 and note 10, p. 68. See further, Guerra, note 17, pp. 91-92.
44. See ECJ, 8 May 1990, Case C-175/88, *Klaus Biehl v. Administration des Contributions du Grand-Duché de Luxembourg* and ECJ, 14 February 1995, Case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker*, as well as Kemmeren, note 10, pp. 53 and 69. Compare further Guerra, note 17, pp. 92-93.