



Lund University

School of Economics and Management
Department of Business Law

**Assessment of "Anti-Hybrid" Approach to the Problem of
Aggressive Tax Planning**

**in the light of the European Commission's proposal to amend Article 4(1)(a) of the
Parent-Subsidiary Directive**

Nataliya Strelnikova

HARN60 Master Thesis

Master's Programme in European and International Tax Law

2013/2014

Spring Semester 2014

Tutor: Cécile Brokelind

Examiner: Axel Hilling

Date: 2 June 2014

Author's contact information:

strelnikova.nata@gmail.com

+46 076-7821931

Table of Contents

| | |
|---|----|
| List of Abbreviations | 4 |
| 1. INTRODUCTION | 5 |
| 1.1 Background..... | 5 |
| 1.2 Purpose | 7 |
| 1.3 Method and Materials | 8 |
| 1.4 Delimitation | 8 |
| 1.5 Outline | 9 |
| 2. BACKGROUND | 9 |
| 2.1 “The debt-equity bias” as a root of the problem..... | 9 |
| 2.2 Classification of hybrid financial instruments..... | 10 |
| 3. CLASSIFICATION PROBLEM IN THE CONTEXT OF OECD MODEL | 11 |
| 3.1 Relevance..... | 11 |
| 3.2 Tax effect..... | 11 |
| 3.3 Interpretation of Articles | 12 |
| 3.3.1 Dividend definition under Article 10(3)..... | 12 |
| 3.3.2 Further Comments | 13 |
| 3.3.3 Interest definition under Article 11 (3)..... | 14 |
| 3.3.4 Interconnection of Article 10 and Article 11 | 14 |
| 3.4 Counteracting measures under OECD Model | 14 |
| 3.5 Final Remarks..... | 15 |
| 4. TAXATION OF HYBRID FINANCIAL INSTRUMENTS UNDER EU LAW | 17 |
| 4.1 General remarks..... | 17 |
| 4.2 Parent-Subsidiary Directive..... | 17 |
| 4.3 Interest and Royalties Directive (“Interest Directive”) | 19 |
| 4.4 Effect of the current version of the Parent-Subsidiary Directive on hybrid financial instruments..... | 20 |
| 4.4.1 Effect of the “fraud and abuse” clause of the Parent-Subsidiary Directive..... | 20 |
| 4.4.2 Effect of the “Subject to” tax clause..... | 21 |
| 4.4.3 “Association” requirement | 21 |
| 4.5 Amendment as a platform for domestic anti-hybrid rules..... | 21 |
| 5. COMPATIBILITY WITH EU LAW | 22 |
| 5.1 General Remarks | 22 |

| | |
|---|----|
| 5.2 Impediments behind denying of the participation exemption | 23 |
| 5.3 Applicable Freedom | 23 |
| 5.4 Existence of different comparable situations..... | 24 |
| 5.4.1 Same treatment? | 24 |
| 5.4.2 Case law on CFC rules | 26 |
| 5.4.3 Case law on inbound dividends | 26 |
| 5.4.4 Disparity | 27 |
| 5.5 Possible justification..... | 27 |
| 5.5.1 Unacceptable justifications..... | 28 |
| 5.5.2 Prevention of tax avoidance | 28 |
| 5.5.3 Balanced allocation of taxing rights | 29 |
| 5.5.4 Prevention of “double dip” | 30 |
| 5.5.5 Coherence of the tax system..... | 30 |
| 5.6 Proportionality Test | 32 |
| 6. CONCLUSION AND FINAL REMARKS..... | 32 |
| Annex A | 35 |
| Annex B..... | 36 |
| Annex C..... | 37 |
| Bibliography | 39 |
| Table of Cases | 43 |

List of Abbreviations

| | |
|------------|--|
| Art | Article |
| BEPS | Base Erosion and Profit Shifting |
| CFC | Controlled foreign company (corporation) |
| CIT | Corporate Income Tax |
| ECJ | European Court of Justice |
| EU | European Union |
| GAAR | General Anti-Abuse Rules |
| MNE | Multinational Enterprise |
| No | Number |
| OECD | Organisation for Economic Co-operation and Development |
| OECD Model | OECD Model Tax Convention on Income and on Capital (2010) |
| P | Page |
| Para | Paragraph |
| Paras | Paragraphs |
| PP | pages |
| Sec. | Section |
| TFEU | Treaty on the Functioning of the European Union |
| Vol. | Volume |
| WHT | Withholding Tax |

1. INTRODUCTION

1.1 Background

Modern financial engineering has paved the way for creation of a great variety of financial instruments, which blend financial elements and other entitlements in one form or another. New “financial gadgets” blurred the underlying legal concepts of debt and equity, thereby making distinction between debt and equity be one of the most prominent problems in tax area.¹

These financial instruments due to their mixed character of debt and equity are called “*hybrid financial instruments*”.² They are primarily used in financing of companies in order to provide certain desired characteristics not present in purer forms of debt or equity.³ For the corporate tax purposes the remuneration derived under hybrid financial instruments is treated dichotomously either as dividend or as interest.⁴ The necessity for precise identification is caused by the different tax treatment of debt (interests) and equity (dividends) in the tax world based on the benefit tax principle. In a cross-border transaction interests are usually deductible in the source state of the borrower and are only taxed in the resident state of the lender. Whereas dividends are usually subject to tax in the source state and are exempt in the state of the capital lender.⁵ Therefore, with a view to the different tax treatment of dividends and interests, inconsistency in qualification by two or more countries can result in either double taxation (*positive classification conflict*) or double non-taxation (*negative classification conflict*).⁶

To this end, in a cross-border context hybrid mismatch arrangements, which exploit differences in the tax treatment of instruments between two or more countries,⁷ have become a widely used tool in sophisticated tax planning structures since a taxpayer using legal arrangements could manage deductibility, inclusion, timing or character of payments made under hybrid financial instruments.⁸ More specifically, MNEs, using hybrid financial instruments, could obtain more incentives to leverage the company in order to benefit from the “*double dip*” phenomenon, based on a deduction by a borrowing company without income inclusion by a lender.⁹ This phenomenon distorts the single tax principle (income should be taxed once - not more and not less), which underlies the coherent international tax regime.¹⁰ Alternatively, hybrid mismatch arrangements may lead to a tax deferral which if

¹ W. Schön, ‘The Distinct Equity of the Debt-Equity Distinction’, *Bulletin for International Taxation*, Vol.66, No 9 (2012), p.491

² P. J. Connors & G. H.J. Woll, ‘Hybrid Instruments – Current Issues’, August (2001), p.1 <http://204.154.93.32/fileupload/5029.pdf> accessed 20.04.2014

³ Ibid

⁴ S. Bärsch, ‘Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context’, Springer-Verlag Berlin Heidelberg (2012), p.86

⁵ S. Bärsch & C. Spengel, Hybrid Mismatch Arrangements: OECD Recommendations and German Practice’, *Bulletin for International Taxation*, Vol.67, No 10 (2013), p.521

⁶ M. Helminen, ‘The Dividend Concept in International Tax Law: Dividend Payments Between Corporate Entities’, Kluwer Law International (1999), p.51

⁷ Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, OECD (2012), p.5

⁸ Peter J. Connors & Glenn H.J. Woll (*n 2*) p.1

⁹ P.H. Blessing, ‘The Debt-Equity Conundrum - A Prequel’, *Bulletin for International Taxation*, Vol. 66, No 4/5 (2012), p.203

¹⁰ Reuven S. Avi-Yonah, ‘Tax Competition, Tax Arbitrage, And The International Tax Regime’, *Bulletin for International Taxation*, Vol. 61, No 4 (2007), pp.135-136

maintained over several years is economically similar to double non-taxation.¹¹

The indicated problem stems from the fact that classification issues are matters for domestic law¹² and contracting states usually do not concern about the treatment of the corresponding payment made under hybrid financial instrument in tax systems of each other. For instance, the recent decision of the Dutch Supreme Court¹³ recognized participation exemption in respect to the payment made under redeemable preference shares by classifying the payment as a dividend even though the paying company in Australia treated the payment as interests and therefore deducted it for tax purposes.

The legal pluralism, which is intrinsic to cross-border taxation,¹⁴ seems to exacerbate the problem of inconsistency classification. On the one hand, the domestic tax law, tax treaties law and EU tax law are independent legal systems of international tax law.¹⁵ On the other hand, notwithstanding that tax treaties are at a different level compared to the domestic legislations of the contracting states,¹⁶ they face legal pluralism as a natural condition for their application, since they permit characterization of dividend based on the domestic law of either contracting state.¹⁷ By contrast, EU Directives should not depend on the internal law classification unless otherwise expressly stated in the Directives,¹⁸ however the Parent-Subsidiary Directive,¹⁹ in its turn, lacks of defined autonomous certain definition. In this way, ambiguous order of priority of these legal systems for classification of hybrid financial instruments leaves the loopholes, which can be exploited in *aggressive tax planning*.

The EU Commission has pointed out that aggressive tax planning consists of “taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability”.²⁰ Despite the fact that hybrid mismatch arrangements is the form of aggressive tax planning, general anti-avoidance rules based on a judicial doctrine such as “abuse of law” cannot be effectively relied on to prevent them.²¹ This doctrine assumes existence of artificial arrangements.²² But hybrid mismatch arrangements do not necessarily lack of genuine economic activity behind them.

However, the recent policy has demonstrated that double non-taxation as a consequence of such mismatches is not going to be tolerated and this issue is in the spotlight on the political, legislative and international levels.²³ The main concern is that the legislation itself gives rise

¹¹ Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, OECD (2012), p.5

¹² Peter H. Blessing (*n 9*) p.203

¹³ Dutch Supreme Court 7 February 2014, no. 12/03540 and no. 12/04640;

http://www.dlapiper.com/en/uk/insights/publications/2014/03/international-tax-news-march-2014/tax-treatment-of-hybrid-finance-instruments/#_ftnref7 accessed on 11.05.2014

¹⁴ Pasquale Pistone, ‘Soft Tax Law: Steering Legal Pluralism towards International Tax Coordination’, p. 99 in Dennis M. Weber, *Traditional and Alternative Routes to European Tax Integration*, IBFD (2010)

¹⁵ M. Helminen, (1999) (*n.6*) p.64

¹⁶ Raffaele Russo, ‘Fundamentals of International Tax Planning’, IBFD (2007), p.13

¹⁷ Article 3.2 of the OECD Model (2010); Pasquale Pistone (*n 14*) pp. 99-100

¹⁸ C. Brokelind, ‘Swedish Supreme Administrative Court Rejects Reference to ECJ Regarding Application of EC Parent-Subsidiary Directive’, *European Taxation*, Vol.45, No 8 (2005), p.326

¹⁹ Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (Parent-Subsidiary Directive)

²⁰ Commission, ‘Recommendation of 6.12.2012 on aggressive tax planning’ C(2012)8806 final, p.2

²¹ Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, OECD (2012), p.13

²² Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas* [2006] ECR I-7995

²³ C(2012)8806 final; Commission, ‘Communication from the Commission to the European Parliament and the Council - An Action Plan to strengthen the fight against tax fraud and tax evasion’ Com (2012) 722 final; Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, OECD (2012); Action Plan on Base Erosion and Profit Shifting, OECD (2013) (Action Plan on BEPS) <http://www.oecd.org/ctp/BEPSActionPlan.pdf>;

to the tax arbitrage opportunities connected with hybrid instruments.

Particularly, the Parent-Subsidiary Directive, which is aimed at “to ensure the neutrality, from the tax point of view, of the distribution of profits by a subsidiary established in one Member State to its parent company established in another Member State”,²⁴ grants Member States an option to refrain from taxing the dividends distributed from non-resident subsidiaries.²⁵ And this option is deemed to be interpreted as such irrespective of the fact that the profit distribution has been treated as a tax-deductible payment in the Member State where the paying subsidiary is a resident.²⁶

In order to “ensure that the application of the directive does not inadvertently prevent effective action against double non-taxation in the area of hybrid loan structures”,²⁷ the Commission proposed to amend the Parent-Subsidiary Directive²⁸ and the European Parliament gave strong backing to this proposal.²⁹

The proposed changes to the Directive are twofold and include, firstly, withdrawal of the tax exemption for a profit distribution that was deductible by the subsidiary of the parent company.³⁰ Secondly, it is proposed to amend the anti-abuse provisions by making them more detailed and therefore bind Member States to follow GAAR.

However, such a technical “point-based” solution of the problem, which is stemmed from the coexistence of taxing sovereignties and legal pluralism, raises certain concerns. Firstly, it increases complexity of tax rules and arguably could have unforeseeable implications. Secondly, even though EU law accepts “linking rules”, which make tax treatment in one country conditional on tax treatment in another country (*e.g.*, CFC rules), they always have to be in compliance with the principles established by the primary EU law.

1.2 Purpose

With acknowledgment that the proposed changes are highly driven by the political debate around aggressive tax planning undertaken by MNEs, the purpose of this paper is to put the proposal, which is aimed at achieving that “not one company can escape taxation by loopholes from hybrid financing in cross-border situations”,³¹ into EU legal framework and consider it in terms of compatibility with non-discrimination principles on fundamental freedoms, established by the ECJ through the case-law. Moreover, the author endeavors to answer to what extent the proposal constitutes comprehensive solution to the problem of hybrid financial instruments mismatches. To this end, the answer cannot be limited to the problem of double non-taxation, but it shall be fairly addressed in terms of double taxation problem as well.

Consideration of the above matters will be supported by the study of the ways how

Commission, ‘Proposal for a COUNCIL DIRECTIVE amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States’ COM (2013) 814 final

²⁴ Case C-247/08 *Gaz de France – Berliner Investissement SA v Bundeszentralamt für Steuern* [2009] ECR I-09225, para 57

²⁵ Parent-Subsidiary Directive, Article 4(1)(a)

²⁶ COM (2013) 814 final, p.3

²⁷ COM (2012) 722 final, p.9

²⁸ COM (2013) 814 final

²⁹ European Commission, STATEMENT/14/92 dd 02/04/2014 available at http://europa.eu/rapid/press-release_STATEMENT-14-92_en.htm?locale=en accessed 20.04.2014

³⁰ the proposed amendment is relevant only to Member States that have chosen to provide exemption for distributions as the option to use the credit method under Article 4(1)(b) remains unchanged

³¹ COM (2013) 814 final, p.4

mismatches are treated in a cross-border context and what solutions of the problems caused by mismatches are provided by the existing legal systems.

1.3 Method and Materials

For the purpose of the research the traditional legal method will be used. Specifically, in order to clarify the issue of classification conflict from the perspective of different legal systems the research will be based on the study of the sources of law. The reference to the relevant existing academic literature will be made with the purpose to obtain valuable commentaries. In addition, soft law such as relevant reports from the OECD is found to give valuable input.

The issue of compatibility with EU law will be considered through the study of the ECJ's case-law. However, taking into account that there is no ECJ's case-law related to the application of the Parent-Subsidiary Directive to hybrid financial instruments, the relevance of case-law is established on the ground of the legal articles, which have addressed the issue of hybrid financial instruments and domestic anti-hybrid rules. In addition, the choice of the relevant case-law is also defined basing on the possibility to draw a parallel between the tax problems, challenged by the ECJ, and the aim of the proposal in question.

Decisions of some domestic cases are deemed to be relevant. Taking into account the lack of official English translation, it has been found necessary to resort to the secondary sources, which set out the decisions in English.

1.4 Delimitation

Firstly, the paper does not assess consequences of the proposed modification to anti-abuse rules of the Parent-Subsidiary Directive. It is acknowledged that the proposal does not constitute the law and the amendment will be enacted only in case of unanimous support by all EU Member States.

Secondly, the issue of hybrid entities, which are treated as opaque in one state and as transparent in another, is not going to be considered in this thesis. This issue was broadly discussed on the OECD report (1999) "The Application of the OECD Model Tax Convention to Partnerships", which led to important amendment of OECD Commentary (2000). The author is aware, that this report addressed the problem of treaty benefits, whereas the Action Plan on BEPS considers the problem also from the prospective of domestic law. However, taking into account that the core of this study is the proposed amendment to the Parent-Subsidiary Directive, it is regarded that hybrid financial instruments are more exposed to its consequences. Therefore, this thesis does not cover the issues related to hybrid entities.

Thirdly, some countries have adopted anti-hybrid rules, which are *not* aimed at linking allowance for dividend exemption at the parent company level to the tax treatment of the correspondent profit distribution at the level of the payer's state, but rather link allowance for deduction at the source state with the tax treatment in the parent company's state.³² It is foreseeable that the coexistence of these rules, each being aimed at preventing double non-taxation, will result in double taxation. However, the problem of "circularly-linked" rules is beyond consideration in this thesis. The rules countering deduction are recommended by OECD Action Plan on BEPS, whereas the rule tackling exemption has the higher priority due to the proposal of the Commission to amend the Parent – Subsidiary Directive. Some observations made by scholars could also support the author's decision to focus on this latter rule. It has been concluded that the need for the capital lender to assess the tax treatment in every country in which the capital borrowers reside could lead to the high administration and

³² Denmark, the United Kingdom see to this end Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, OECD (2012), p.17

compliance cost. Therefore, “the OECD recommendation that the tax treatment at the level of the payer should refer to the tax treatment at the level of the recipient should be rejected”.³³

1.5 Outline

Chapter 2 of the thesis is aimed at giving insight into hybrid financial instruments with regard to the issue of debt - equity distinction and the classification approach.

Then the paper proceeds to consider, in *Chapter 3*, the role of double tax treaties in dealing with the classification conflict using the OECD Model as an example.

Chapter 4 focuses on tax implications of the cross-border transactions in the context of classification conflict in relation to hybrid financial instruments under the Parent-Subsidiary Directive and the Interests and Royalty Directive.

Compatibility of the proposed amendment with EU law are discussed in *Chapter 5*, which is followed by the final conclusions in *Chapter 6*.

2. BACKGROUND

2.1 “The debt-equity bias” as a root of the problem

According to the standard Modigliani-Miller (1968) theorem a firm is indifferent between financing either through issuing stocks (equity) or debt, under the assumption that there are no taxes, no asymmetric information and no bankruptcy and agency costs. But in reality firms deviate from this rule, mainly due to existence of taxes.³⁴

In accordance with the fundamental principle of taxation as neutrality, taxes should not influence taxpayers’ decisions. With respect to financial instruments, the most important neutrality consideration concerns the decision on different modes of finance (financial neutrality) such as new equity issues or debt capital.³⁵ However, transactions on the debt side generally receive favorable treatment. Transactions on the equity side do not.³⁶ Such a different tax treatment of debt and equity, i.e. “the debt-equity bias”,³⁷ therefore, distorts financing decisions of corporations and induces financing through debt, rather than equity. This difference in treatment substantially infringes the concept of equal treatment under tax law and of neutrality from the viewpoint of public finance.³⁸

Although, there are no objective legal reasons to distinguish between both sources of financing.³⁹ It is regarded that the rise in administrative complexity would rather call for a similar tax treatment. Consequently, it is likely that the distinction originates in an artificial distinction made by the traditional view that dividends were merely seen as the remuneration

³³ S. Bärsch & C. Spengel (*n.5*), p.526

³⁴ S. Fatica, T. Hemmelgarn, G. Nicodème, ‘The Debt-Equity Tax Bias: consequences and solutions’, Taxation Paper No 33 (2012)
http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_33_en.pdf accessed 19.04.2014

³⁵ S. Bärsch (*n 4*) pp.44-45

³⁶ while dividends are usually subject to taxation at the source state, interests are tax deductible. Nathan R. Christensen, ‘The Case for Reviewing Debt/Equity Determinations for Abuse of Discretion’, *University of Chicago Law Review*, Vol. 74, No 4 (2007), p.1315

³⁷ Commission, ‘Tax Reforms in EU Member States 2011’, *European Economy*, No 5 (2011), p. 56

³⁸ W. Schön (*n 1*) p.490

³⁹ S. Fatica, T. Hemmelgarn, G. Nicodème (*n 34*) p.6

of capital while interest payment constitutes a business cost.⁴⁰ In addition, the concept of income as a tax base does not require this divide at all.⁴¹ On the other hand, it is discussed among the scholars that necessity for the tax legislator to make additional choices and existence of a wide range of additional specifics in national tax systems contribute to the relevance of the debt-equity distinction.⁴²

Correcting the debt bias may well lead to beneficial effects.⁴³ For instance, Schön considers that with regard to the sophisticated techniques for tax arbitrage, abolition of the distinction between debt and equity turns to be a practical necessity for the smooth functioning of national and international tax law.⁴⁴ However, he recognizes that with a view to the current tax policies around the world the debt-equity distinction for the time being is inevitable.⁴⁵

2.2 Classification of hybrid financial instruments

The different combinations of financial elements (risks and rewards) and other entitlements (voting rights, cancellation rights, conversion rights, etc.) lead to a vast number of possible financial instruments.⁴⁶ The spectrum of hybrid instruments ranges from corporate shares with features typical of loans (such as certain preference shares) to loans with features usually associated with equity investments (such as participation in profit and loss). Such equity-type loans would include *inter alia* jouissance rights, silent partnerships, participation bonds, convertible bonds, warrant bonds, profit participation loans and preference shares.⁴⁷

As an example, a widely used hybrid financial instrument is the “profit- participating loan” (PPL). Countries such as Belgium, France, Spain, Hungary usually classify PPL under civil law as a debt, and, consequently, the payment made in relation to the loan is deductible. Whereas countries such as Luxembourg and the Netherlands consider that this instrument is similar to a shareholding in a subsidiary and, consequently, the payment made in relation to this instrument can be classified as dividend.⁴⁸ It has been found that such a scheme has proliferated in respect of the Netherlands – Hungary double tax convention.⁴⁹

As it has been pointed out above, classification of the payment is the matter of the internal law. To this end, member states have adopted different tax classification approaches based on case law, civil law classification and/or accounting law. However, such formal adherence to the concept of debt and equity under civil law and corporate law is criticized for missing the underlying rationale of the debt-equity divide in the world of corporate income taxation and also for the inappropriateness in the context of international allocation of taxing right.⁵⁰ It could be argued that distinction between debt and equity shall be made basing on the economic substance of rights and obligations with its most important distinctive

⁴⁰ Ibid p.6 with reference to M. Devereux & A. Gerritsen, The tax treatment of debt and equity, in: D.A. Albrecht & P. Kavelaars, Naar een Europese Winstbelasting, Deventer: Kluwer 2010

⁴¹ W. Schön (n 1) p.492

⁴² W. Schön (n 1) pp.492-493

⁴³ S. Fatica, T. Hemmelgarn, G. Nicodème (n 34) p.6

⁴⁴ W. Schön (n 1) p.491

⁴⁵ W. Schön (n 1) p.502

⁴⁶ W. Schön (n 1) p.491; S. Bärsch (n 4) p.82

⁴⁷ Eberhartinger, Eva and Six, Martin ‘National Tax Policy, the Directives and Hybrid Finance. Options for tax policy in the context of the treatment of Hybrid Financial Instruments in the Parent- Subsidiary Directive and the Interest and Royalties Directive’. Discussion Papers SFB International Tax Coordination, 16. SFB International Tax Coordination, WU Vienna University of Economics and Business, Vienna (2006), p.5

⁴⁸ see to this effect, http://www.belastingrechtenaandevu.nl/Portals/0/images/Boulogne_artikel20_Engels.pdf p.2-3

⁴⁹ TAXUD D1 D(2012), *Summary report of the responses received on the public consultation on*

factual examples and possible ways to tackle double non-taxation cases, 5 July 2012, p.15

⁵⁰ W. Schön (n 1) pp.495-496

characteristics. For this purpose S. Bärsch⁵¹ indicated an appropriate array(s) of rights and obligations by means of which economic substance of a financial instrument can be classified either as debt or equity (see *Annex A*). It demonstrates the divergence of distinctive elements of pure debt and pure equity, which could give first indications on which form prevails more than another one. He expresses the view that if such arrays of rights and obligations are agreed upon, pure equity and pure debt exist, which may conduce to the further analysis for the tax purposes and should give first indications whether a hybrid financial instruments substitutes one form more than another.⁵²

3. CLASSIFICATION PROBLEM IN THE CONTEXT OF OECD MODEL

3.1 Relevance

Taking into account the foregoing discussion two points have to be highlighted. First, each EU country treats hybrid financial instruments within the frames of its domestic tax law according to its sovereign powers. Second, tax classification of the payment made under hybrid financial instrument as interest or dividend is crucial for the allocation of taxing rights.⁵³ However, the influence of double tax treaties on the taxation in a cross-border context is of great importance. This is based on the fact that income tax treaties are capable to limit the legitimate taxing right of each contracting state, which is, within the limits of international law, widely sovereign in levying taxes.⁵⁴

With a view to the great number of income tax treaties and for the purpose of this research, the OECD Model is taken as a basis since the majority of bilateral tax treaties are based on it. Coming out of the fact that the remuneration from hybrid financial instruments is generally classified either as dividends or interests, Art 10 and Art 11 respectively are relevant for consideration. With regard to the derivatives, Art 21 (other income) becomes highly relevant, but in general it exceptionally applies to capital-raising financial instruments. Art. 13 (capital gains) could be also ignored, as it covers gains from the alienation of hybrid financial instruments, but not the remuneration derived therefrom. Further, Art 7 (business profit) is relevant in case if the capital lender carries on business in the source state through a PE and interest and dividends paid are effectively connected with this PE.⁵⁵ Therefore, for the purpose of this thesis the study is limited by Art 10 and Art 11.

3.2 Tax effect

Taxing rights of contracting states differ depending on the category of the income item. Both Art 10 and Art 11 grant unlimited taxing rights to the resident state whereas the taxing rights of the source state are limited by the fixed rate of withholding tax depending on the category of income.⁵⁶ In this way, contracting states retain certain liberty in defining the amount of withholding tax to be retained by the source state. It has been observed, however, that more frequently applied double tax treaties deny the source right to levy withholding tax in cases

⁵¹ S. Bärsch (*n 4*)

⁵² S. Bärsch (*n 4*) pp.82-84

⁵³ S. Bärsch (*n 4*) p.2

⁵⁴ S. Bärsch (*n 4*) p.94

⁵⁵ S. Bärsch (*n 4*) p.94

⁵⁶ OECD Model (2010), Article 10 allows 5% withholding tax if the beneficial owner is a company which holds directly at least 25%; 15 % in other cases. Article 11 allows 10% withholding tax.

for interest payment than for dividends. Therefore, the classification of the remuneration paid under hybrid financial instrument is deciding in whether withholding tax can be levied or in what amount.⁵⁷ It should be noted that when a source state does not impose a withholding tax to interests payment made in case of the hybrid mismatch, the taxpayer can end up with triple non-taxation (*white income*).⁵⁸

3.3 Interpretation of Articles

It is generally regarded that the tax treaty classification is independent of domestic tax law classification.⁵⁹ According to Lang⁶⁰ each double tax treaty has to be interpreted autonomously, that is to say independent from the national tax law of the contracting states as long as no direct reference to the national law of one of the contracting state is made. Thus, further it will be considered whether the definitions of dividend and interest are exhaustive and independent of the domestic law.

3.3.1 Dividend definition under Article 10(3)

Definition of dividends under OECD Model can be divided into three groups. The first two groups include “income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits...”⁶¹. This dividends’ definition constitute autonomous parts and shall be interpreted independent from the national law of the source state.⁶²

The third part of definition includes “income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident”⁶³. In contrast to the definition of first groups, *income from other corporate rights* is affected by the reference to the national law of the source state, therefore making this law to be a part of the treaty between two contracting states.⁶⁴ To this end, the source state is entitled to classify the payment made in connection with hybrid instrument in accordance to its domestic tax laws. However, it is questionable that the reference to the source state internal law in Art 10(3) could serve as an indication for the residence state of an income recipient to accept the classification of the source state under an income classification conflict. And the concern that lies behind this is related to the interpretation of the term “corporate right”.

Being guided by the meaning of dividends, it could be concluded that the term “corporate rights” is a distinctive element for the qualification of income as dividends.⁶⁵ Accordingly, only the remuneration derived from corporate rights can be expected to fulfill the dividend definition.⁶⁶ In such a way, the term “corporate right” plays a crucial role for the dividend definition. However, since the term is not defined in OECD Model, its interpretation shall be

⁵⁷ Eberhartinger, Eva and Six, Martin, ‘Taxation of Cross border Hybrid Finance. A legal Analysis.’ Discussion Papers SFB International Tax Coordination, 27. SFB International Tax Coordination, WU Vienna University of Economics and Business, Vienna, (2007), p.9

⁵⁸ null withholding tax on interests could be fixed either under domestic tax law or under a double tax treaty. Eberhartinger, Eva and Six, Martin (2007) (n 57) pp.5,7

⁵⁹ M. Helminen, ‘Classification of Cross-Border Payments on Hybrid Instruments’, *Bulletin for International Taxation*, Vol.58, No 2 (2004), p.57

⁶⁰ Eberhartinger, Eva and Six, Martin (2007) (n 57) p.9 with further citing

⁶¹ Art. 10(3)

⁶² Eberhartinger, Eva and Six, Martin (2007) (n 57) p.10 with further citing

⁶³ Art. 10(3)

⁶⁴ Eberhartinger, Eva and Six, Martin (2007) (n 57) p.10 with further citing

⁶⁵ R. Tomazela Santos, ‘Tax Treaty Qualification of Income Derived from Hybrid Financial Instruments’, *Bulletin for International Taxation*, Vol.67, No 10 (2013), p.4

⁶⁶ S. Bärsch (n 4) p.99

made in accordance with the rule of Art. 3(2) of the OECD Model, i.e. in accordance with the law of the state applying the treaty, unless the context otherwise requires.⁶⁷

To this effect, the resident state of the income recipient has the right to invoke its own law to determine whether the income has derived from the corporate rights. If it ends up by concluding that the hybrid financial instrument does not constitute the corporate right, then the residence state may deny the dividend treatment of the corresponding payment and classify it as interest for the tax purpose. As a result, double taxation will arise.⁶⁸

Therefore, there is no obligation under OECD Model for the resident state to accept the dividend treatment of the source state.

3.3.2 Further Comments

The Commentary on Art 10 seems to accept a lack of fully and exhaustive definition and explains this by “the great differences between the laws of OECD member countries”. Consequently, the notion of dividends is still closely connected with domestic laws of each member country “in view of the still remaining dissimilarities between Member countries in the field of company law and taxation law”.⁶⁹

As pointed out by van Weegel hybrid instruments is a particular area where the lack of exhaustive definition or the reference to the domestic laws leads to troublesome conclusions.⁷⁰

Helminen upholds that the classification conflict such as the one described in Sec. 3.3.1 is the best avoided when the treaties deviate from the OECD Model. More specifically, when double tax treaties do not use the term “corporate rights” in the third part of the dividend definition, which refers to the source-state classification, the residence state is required to accept the source state dividend classification of the payment on hybrids.⁷¹ For instance, it has been found that the Germany - United States Income and Capital Tax Treaty refers in the third part of the dividends definition to the «other income from *other rights*». ⁷² Helminen also points out that under the Nordic Convention treatment as dividends does not require the existence of corporate rights, which reduces the danger of unresolved classification conflicts, as compared to the OECD Model.⁷³

By the same token, Tomazela Santos supports the idea of eliminating the reference to domestic legislation for dividend definition through an exhaustive and full definition, which would provide greater legal certainty.⁷⁴

By contrast to the above, a more general opinion also exists stating that the tax treaty qualification of the income needs to co-exist with the domestic tax qualification of the income; as uniform treaty qualification may not solve all conflicts arising from the interaction

⁶⁷ M. Helminen (n 59) p.58

⁶⁸ M. Helminen (n 59) p.61

⁶⁹ OECD Commentary 2010, par.23 to Article 10

⁷⁰ van Weeghel, S., ‘Dividends (Article 10 OECD Model Convention)’, p.67 in Michael Lang, ‘*Source versus Residence*’, Kluwer Law International BV, the Netherlands, 2008

⁷¹ M. Helminen (n 59) p.61

⁷² Article 10(5) of Germany - United States Income and Capital Tax Treaty (as amended through 2006)

⁷³ M. Helminen, ‘Dividends, Interest and Royalties under the Nordic Multilateral Double Taxation Convention’, *Bulletin for International Taxation*, Vol. 61, No 2 (2007), p.55

⁷⁴ R. Tomazela Santos (n 65) p.7

between the tax regimes of both contracting States plus the requirements of the treaty upon each of them.⁷⁵

3.3.3 Interest definition under Article 11 (3)

Unlike the definition of dividends, Article 11 (3) of OECD Model does not contain any reference to the source state income classification. The definition of interests is limited to the “income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits”. Therefore it has to be recognized as a final and all-embracing definition of the term interest,⁷⁶ which restricts the qualification competence of the source state to the precise terms of the treaty provision.⁷⁷

The decisive element of the interest definition is the expression “*income from debt-claims of every kind*”. The expression is not defined in the Model or Commentaries and just followed by the exemplary enumeration of certain kinds of debt claims, which does not influence the universal character of the term itself.⁷⁸

3.3.4 Interconnection of Article 10 and Article 11

It has been illustrated that OECD Model provides for different approaches in defining of interests and dividends. In this respect the question which classification must prevail has to be raised.

Some suggestions could be interfered from the OECD Commentary. Paragraph 19 of the Commentaries on Art 11 envisages the possibility of overlap between the categories of income and therefore it clarifies that the term “interest” does not include items of income, which are dealt with under Art 10. Consequently, for - limited or not - tax treaty purposes dividend income classification takes precedence over interest income classification.⁷⁹ Therefore if the income from financial instruments by falling within qualification as corporate rights, classifies as dividend under Art 10 of the OECD Model, such yield cannot fall under Art 11 of the OECD Model even if it would qualify as interest in terms of Art 11, as the terms of *income from corporate rights* and *income from debt claims* are mutually exclusive.⁸⁰

However, it turns to be challenging to come out to a safety answer what qualification shall prevail when the same income from hybrid financial instrument is treated as a dividend income under domestic law of the source state and as an interest income under terms of Art 11.⁸¹ According to the Commentary the dividend definition shall take precedence. On the other hand, it has been observed that the closed treaty definitions of interests should prevail over open treaty definitions of dividends “in order to favor homogeneous and international tax treaty definitions of income”.⁸²

3.4 Counteracting measures under OECD Model

Even though the residence state is not bound to follow the source state classification of the payment made under hybrid financial instrument, OECD Model provides specific tools to the residence state to deal with the consequences of the classification conflict.

⁷⁵ F.A.G. Prats, ‘Qualification Of Hybrid Financial Instruments In Tax Treaties’, *Diritto E Pratica Tributaria Internazionale*, Vol. VIII, No 3 (2011), p.988 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2257065 accessed 10.04.2014

⁷⁶ Eberhartinger, Eva and Six, Martin (2007) (*n 57*) p.12 with further citing

⁷⁷ R. Tomazela Santos (*n 65*) p.6 citing A. Xavier (2010)

⁷⁸ Eberhartinger, Eva and Six, Martin (2007) (*n 57*) p.12

⁷⁹ F.A.G. Prats (*n 75*) p.986

⁸⁰ Eberhartinger, Eva and Six, Martin (2007) (*n 57*) p.12 with further citing

⁸¹ F.A.G. Prats (*n 75*) p.986

⁸² *Ibid* p.987

Double non-taxation resulted from the classification inconsistency may be solved through Art. 23A(4).⁸³ The objective of this provision according to the Commentaries is to “avoid double non taxation as a result of disagreements between the State of residence and the State of source on the facts of a case or on the interpretation of the provisions of the Convention”.⁸⁴ It entitles the resident state to switch from the exemption method and to tax the income in cases where the source state applies the provisions of the convention to exempt such income or applied to such income reduced tax rate on dividends or interests. In view of the nature of the provision, it is relevant for countries, which have adopted the exemption method to provide double taxation relief. However, it cannot be concluded for certain that countries, which use the exemption method, actually have adopted this provision in their tax treaties.⁸⁵ Moreover, notwithstanding that these clauses could eliminate double non-taxation, they are found to be more restrictive on taxpayers and therefore within EU they could be adverse to the fundamental freedoms of TFEU.⁸⁶ On the other hand, one could notice that in *Columbus Container*⁸⁷ the ECJ ruled that the switch-over clause was compatible with the fundamental freedoms.

Following on the Commentaries on Art.23,⁸⁸ Par. 1 of the Art. 23(A) can also work *per se* as a switch-over clause in cases of “negative qualification” by interpreting the meaning “*may be taxed in the other contracting state*”.⁸⁹ It implies that the state of residence is not required to exempt the income where the source state is precluded to execute its taxing rights as a result of the treaty interpretation and therefore, the State of residence should consider that the item of income *may not be taxed* by the State of source in accordance with the provisions of the convention. Consequently, it could be in general inferred that under the OECD Commentary the residence state is not bound by the treaty classification of the income made by the source State, but rather by the result of such a classification made by the source State.⁹⁰

Another alternative to eliminate double non-taxation caused by the different interpretation and application of either the double tax treaty or by the simultaneous application of the domestic tax laws of the Member States is to accompany the exemption method by a “*subject to tax*” clause, which ensures application of exemption method to the extent that the correspondent income was effectively taxed in a source state. Also, the Commission, in addressing issues of aggressive tax planning, has encouraged Member States to include this clause in double taxation conventions in order to ensure that commitment of one contracting state not to tax a given item of income shall apply where the item is subject to tax in the other contracting State.⁹¹

3.5 Final Remarks

In the light of the foregoing it could be resumed that a tax treaty based on the current version of OECD Model is not an adequate tool to solve the qualification conflict⁹² and the reference

⁸³ introduced in 2000

⁸⁴ Commentaries to the OECD Model (2010), para 56.1 to Article 23A(4)

⁸⁵ Shee Boon Law, ‘Anti-Avoidance Rules in Recent Tax Treaties’, *Bulletin for International Taxation*, Vol.66, No 6 (2012), p.320

⁸⁶ Commission, ‘Summary report of the responses received on the public consultation on factual examples and possible ways to tackle double non-taxation cases’ TAXUD D1 D(2012), p.16

⁸⁷ Case C-298/05 *Columbus Container Services BVBA & Co. v. Finanzamt Bielefeld-Innenstadt* [2007] ECR I-10451

⁸⁸ Commentaries to OECD Model (2010), para.32.5 to Article 23A

⁸⁹ Article 23(A) (1) of OECD Model (2010); Commentaries to OECD Model (2010), para 32.6 to Article 23; Lang, M, ‘Tax Treaties: Building Bridges between Law and Economics’, IBFD (2010), p.342

⁹⁰ F.A.G. Prats (*n* 75) p.995

⁹¹ C(2012)8806 final, p. 4

⁹² Eberhartinger, Eva and Six, Martin (2007) (*n* 57) p.13

to the domestic law in case of dividend definition seems to be accepted as a natural condition for the application of the double tax treaties. However, with the view that the tax treaty qualification is valid for determination of the allocation taxing rights and it does not cover and does not necessarily impact domestic tax regime (e.g., timing issues and criteria being used for realization of income, determination of the deductibility or the non-deductibility of certain payments as cost), it could be concluded that the tax treaty qualification serves a very limited purpose. To this end, a mandatory and universal qualification of the income under a double tax treaty does not necessarily lead to the coherent tax treatment of a cross-border transaction.⁹³

Elimination of double taxation is inherent to the double tax treaties, but the issue of double non-taxation has been subject to intense debate recently. It is discussed that the objective of tax treaties *de lege lata* is not preventing double non-taxation as Contracting States may anticipate. It is a widely held view that the OECD Model neither clearly states what is the position of the Model itself, nor contains specific measures to counteract or prevent double non-taxation.⁹⁴ In this respect, EU law does not also restrict double non-taxation caused by tax treaties.⁹⁵

It is worth to emphasize that BEPS Action 6 (*Prevent Treaty Abuse*)⁹⁶ proposes to clarify that tax treaties shall not be used with the target to generate double non-taxation. For this purpose it is suggested that the title and preamble of the OECD Model shall be amended as to state clearly that the prevention of tax evasion and avoidance is a purpose of tax treaties.⁹⁷ It is assumed that clear statement of the signatories' intention will be relevant to the interpretation and application of the provisions of the treaty.⁹⁸ However, the commentators express another opinion. It is observed that tax treaties are aimed "to facilitate cross-border trade and investment through the removal of barriers to investment, including double taxation" and therefore, it is risky to state that the purpose of tax treaties is to prevent abuse of treaties.⁹⁹ They should not be used as an anti-avoidance tool and the only avoidance to be addressed in treaties should be where benefits are obtained under the Treaty in an artificial manner.¹⁰⁰ This idea seems to be relevant for the further discussion of the denial of the Parent-Subsidiary Directive benefits.

⁹³ F.A.G. Prats (*n* 75) p.983

⁹⁴ *Ibid* p.994

⁹⁵ M. Helminen, 'The Problem of Double Non-Taxation in the European Union – To What Extent Could This Be Resolved through a Multilateral EU Tax Treaty Based on the Nordic Convention?', *European Taxation*, Vol.53, No 7 (2013), p.307

⁹⁶ Action Plan on BEPS, OECD (2013)

⁹⁷ Public Discussion Draft: BEPS ACTION 6: PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES 14 March 2014 – 9 April 2014, p.27

<http://www.oecd.org/ctp/treaties/treaty-abuse-discussion-draft-march-2014.pdf> accessed 23.03.2014

⁹⁸ *Ibid* p.28

⁹⁹ BIAC's comments received on public discussion draft BEPS ACTION 6: PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES 11 April 2014, p.2

<http://www.oecd.org/tax/treaties/comments-action-6-prevent-treaty-abuse.pdf> accessed 05.05.2012

¹⁰⁰ *Ibid.*, p.12

4. TAXATION OF HYBRID FINANCIAL INSTRUMENTS UNDER EU LAW

4.1 General remarks

In the previous chapter it has been discussed that the application of double tax treaties has a limited impact on the tax treatment of hybrid financial instruments.

At the present stage of EU law in the area of direct taxation Member States are free to design their tax systems in accordance with the domestic policy objectives and requirements as long as the domestic tax rules do not constitute a forbidden discrimination or restriction under the TFEU.¹⁰¹ Consequently, EU law does not have an effect on classification of hybrid instruments made under domestic tax rules. However, on the other hand, the Member States' autonomy in the area of direct taxation is restricted both by secondary EU law in the form of directives, which are used to advance the Single Market, and primary EU law such as the fundamental freedoms, which eliminate disadvantages of cross-border transactions in comparison with the purely domestic transactions.¹⁰²

In a cross-border context in terms of taxation of hybrid financial instruments the Parent-Subsidiary Directive and the Interest and Royalty Directive¹⁰³ are of the most relevance as the remuneration from the hybrid instruments may fall within competence of one of them. Therefore, further it is aimed at analyzing in what way the current versions of the indicated Directives affect the classification and taxation of the remuneration paid under hybrid instruments.

4.2 Parent-Subsidiary Directive

The aim of the Parent-Subsidiary Directive is to facilitate the grouping together of companies at Union level.¹⁰⁴ The benefits of the Directive apply to distributions of profits by a subsidiary to a parent company by virtue of an association between the companies.¹⁰⁵ However, the term "profit distribution" is not specified in the Directive. This creates a number of uncertainties by leaving it for the Member States and their national definitions to decide which profits to include within the scope of the national application of the directive.¹⁰⁶

In clarifying the context of the notion "profit distribution" it has been, however, acknowledged that this term is somewhat broader than the term "dividend" and should cover any payment by the subsidiary to the parent company based on the shareholder-company relationship or the association between the companies.¹⁰⁷

Notably, that there is no ECJ or national court case-law concerning the clarification of the notion "profit distribution."¹⁰⁸ As a result, since harmonization in EU law requires for the

¹⁰¹ Case C-319/02 *Petri Manninen* [2004] ECR I-07477, para.19

¹⁰² Georg Kofler and Mario Tenore, 'Fundamental Freedoms and Directives in the Area of Direct Taxation', p.322 in Dennis M. Weber, *Traditional and Alternative Routes to European Tax Integration*, IBFD (2010)

¹⁰³ Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (Interest and Royalty Directive)

¹⁰⁴ Case 168/01 *Bosal Holding BV v. Staatssecretaris van Financiën* [2003] ECR I-09409, para.22

¹⁰⁵ Parent-Subsidiary Directive, Article 1 (1), Article 4 (1)

¹⁰⁶ Eberhartinger, Eva and Six, Martin (2006) (*n 47*) p.14

¹⁰⁷ M. Helminen (*n 59*) p.60; J. Bundgaard, 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives –Part 1', *European Taxation*, Vol.50, No 10 (2010), p.448

¹⁰⁸ C. Brokelind (*n 18*) p.326

definition, which would be independent from the definitions of dividends in internal law and bilateral tax treaties,¹⁰⁹ scholars have extensively discussed the degree of the term interpretation autonomy. While many scholars have concluded that the definition requires an autonomous interpretation, at the same time they have been reluctant to recognize an autonomous understanding that this definition is totally independent from the domestic law meanings.¹¹⁰ As a result, it is preferable for the ECJ to lay down certain criteria that may be applied by national authorities within the framework of their national systems of company taxation.¹¹¹

One of the main concern outlined in the discussion is whether the interest on hybrid debt treated as dividends under domestic law of the source state shall be qualified as distributed profits under Art 1 of the Parent-Subsidiary Directive and whether the participation via hybrid instruments shall be attributable to the holding level required under Art 3. This is of particular importance in the light of the purpose of the Directive to eliminate double taxation¹¹². Exclusion of the interest on hybrid debt treated as dividends under domestic law of the source state from the scope of the Directive could lead to multiple taxation because the source state will deny the deductibility of the remuneration due to the domestic classification whereas the resident state will not apply the provisions of the Parent-Subsidiary Directive and will also tax the payment made under hybrid financial instrument.

Within the framework of this paper the debate on the applicability of the Parent-Subsidiary Directive to the interests on hybrid debt, which are treated as dividends in the source state, is summarized briefly with the purpose to illustrate the existence of loopholes.

To recapitulate, since the source state treats payments on hybrid instruments as dividends under national tax law, one cannot withdraw benefits of the Parent-Subsidiary Directive to such payments. However, there is no definite conclusion on whether the state of residence of the parent company has to accept the classification of the source state and therefore grant the benefits of the Parent-Subsidiary Directive symmetrically.¹¹³ Although, it is accepted that the parent state cannot be required to accept the qualification of the source state in any event, since this would give the source state too much power to collect tax revenues in comparison to the state of residence of an income recipient.¹¹⁴ But there are compelling arguments to do so at least in the following two cases¹¹⁵: 1) if, in the opposite situation, the residence state itself would have reclassified the payment on hybrid instrument as dividend; 2) if the residence state has to accept a dividend treatment for tax treaty purposes.

* * *

It is relevant to emphasize that the current version of the Parent-Subsidiary Directive left the door open for the (economic) double taxation in a situation, when a source state classifies the payment as a dividend and a residence state of the parent company classifies it as an interest. No uniform guidelines to the interpretation of the term “profit distribution” and existence of the classification conflict facilitate existing of the double taxation.¹¹⁶ To the best of the

¹⁰⁹ Ibid with reference to B.J.M. Terra and P.J. Wattel, *European Tax Law*, 3rd edition (Deventer: Kluwer, 2001), pp. 354 et seq

¹¹⁰ J. Bundgaard (2010) (*n 107*) p.447, see footnotes 46, 54

¹¹¹ J. Bundgaard (2010) (*n 107*) p.448 with further citing

¹¹² Parent-Subsidiary Directive, Preamble (3)

¹¹³ Eberhartinger, Eva and Six, Martin (2007) (*n 57*) p.22

¹¹⁴ M.Helminen (1999) (*n 6*) p.267

¹¹⁵ M.Helminen (1999) (*n 6*) p.269; Eberhartinger, Eva and Six, Martin (2007) pp.22-23;

¹¹⁶ Eberhartinger, Eva and Six, Martin (2007) (*n 57*) p.22

author's knowledge, this problem has not been raised in the current discussion of the Directive, therefore setting unequal approaches to handling the Single Market problems.

In addition, interpretation of the tax treaty and Commentaries on the OECD Model in order to solve the classification problem under the Parent-Subsidiary Directive is a very controversial approach, which could have undesirable and far-reaching effects.¹¹⁷

4.3 Interest and Royalties Directive (“Interest Directive”)

The Directive definition of the interest mirrors the one embodied in Art. 11 of the OECD Model. At first sight it appears particularly wide, but at the same time the Article 4 of the Interest Directive allows the Member State, where the interest arises, to deny the application of the Directive in certain specific cases.¹¹⁸ For the purpose of the paper cases stipulated by articles 4 (b) – (d) are relevant.

Article 4(b) allows one to deny the Directive benefits in respect of income from profit-sharing loans, e.g. loans where the interest rate is typically linked to the borrower's profit. Article 4(c) and 4(d) refer to specific typologies of debt instrument that carry a certain equity-related element (“quasi-equity”).¹¹⁹

It is regarded that these Articles apply in cases where the treatment under the domestic tax law of the source state corresponds to the general definition of interest states in the Directive.¹²⁰ Therefore, payment under debt claims may still be characterized as interest under the domestic laws of the source state but may nonetheless be subject to withholding tax on interest in the same state.¹²¹

In this way, as Distaso/Russo assumed that the Interest Directive aims to “hit” those hybrid instruments that create a tax deduction in the source state and which give rise to an exemption from taxation of the correspondent income in the residence state, which classifies the corresponding payment as a profit distribution and therefore, extends the benefits of the Parent-Subsidiary Directive to it.¹²² However, it has been argued that even if the elimination of double non-taxation was the ration behind Art 4, the provision does not constitute adequate and reliable instrument. When the resident state treats the payment symmetrically as an interest, application of the Article results in double taxation.¹²³

Similarly, the amendment of Art 4 of the Parent-Subsidiary Directive on a unilateral basis could facilitate arising of (judicial) double taxation in a situation, when the source state treats the payment as interest under domestic tax law, but withdraws benefits of the Interest Directive based on Art 4, whereas the resident state also withdraws the benefits of Parent-Subsidiary Directive on the ground of the payment deductibility in the source state (see *Annex B - Figure 1*). It is getting more complicated with a view that the resident state is not obliged to credit the withholding tax, which is not permitted under its interpretation of the double tax treaty.¹²⁴

¹¹⁷ C. Brokelind (*n 18*) p.327

¹¹⁸ M. Distaso and R. Russo, ‘The EC Interest and Royalties Directive – A Comment’, *European Taxation*, Vol. 44, No 4 (2004), p.149

¹¹⁹ M. Distaso and R. Russo (*n 118*) p.150

¹²⁰ Eberhartinger, Eva and Six, Martin (2007) (*n 57*) p.23

¹²¹ M. Distaso and R. Russo (*n 118*) p.150

¹²² Ibid

¹²³ Eberhartinger, Eva and Six, Martin 2007 (*n 57*) p.23

¹²⁴ Ibid p.9

By contrast, one could argue that companies are well aware of the risk and usually choose a source state with no withholding tax on foreign interests or with double tax treaty that establishes a null withholding tax rate in that state. Therefore, the denying of the benefits of the Interest Directive does not have the real effect. However, this argument seems to be too precipitate to rely on in order to create a “level playing field” as designed by the legislators.

4.4 Effect of the current version of the Parent-Subsidiary Directive on hybrid financial instruments

It seems that the Commission proposal on amendment of Parent-Subsidiary Directive is based on the firm assumption that under the current version of the Directive Member States always have to grant participation exemption, even if the source state does not tax the correspondent profit distribution.

This Section will consider the question whether the current version of the Parent-Subsidiary Directive provides for any solutions capable to ensure exclusion of financial instruments with “negative” classification from the scope of the Directive.

As the starting point for consideration, it is established case-law that the application of the exemption method set out in Art 4(1) in the current version of Parent-Subsidiary Directive “is not subordinated to any condition and is expressly subject only to Articles 4(2) and (3) and 1(2) of that directive”.¹²⁵ From this perspective and for the purpose of this Section, Art 1(2) is relevant and will be considered first.

4.4.1 Effect of the “fraud and abuse” clause of the Parent-Subsidiary Directive

The question considered further is whether the Directive provision on applicability of domestic or agreement-based provisions required for the prevention of fraud or abuse¹²⁶ could serve as an efficient way to exclude hybrid instruments, which are treated as debt at a source Member State, from the scope of the Directive benefits.

However, it is questionable that deductibility on the level of a paying company resulted from different qualification as a result of simultaneous application of autonomous classification methods undertaken by Member States as a part of their autonomy in respect of tax policy in the area of direct taxation, constitutes fraud or abuse. There is also lack of evidence that double non-taxation created by this kind of disparities in tax classification could be regarded as abusive. J. Schwarz¹²⁷ considers that the expression of double non-taxation is “conceptually dubious” and it is “an obvious consequence of the exercise in parallel by Member States of their fiscal sovereignty”.

The abuse of law doctrine in EU law implies creation of wholly artificial arrangement, which is not always the case when hybrid financial instruments are used. The more detailed consideration on applicability of abuse of law concept to the hybrid financial instruments is considered in Section 5.5.2 hereof. However, it is justified to conclude that the “fraud and abuse” clause of the Parent-Subsidiary Directive provides for the opportunity to exclude from the benefits of the Directive only those hybrid financial arrangements, which constitute wholly artificial arrangements.

¹²⁵ Case C-138/07 *Belgische Staat v. Cobelfret NV* [2009] ECR I-00731, para 33

¹²⁶ Parent-Subsidiary Directive, Article 1(2)

¹²⁷ J. Schwarz, ‘Double Taxation in the European Single Market’, *Bulletin for International Taxation*, Vol.66, No 6 (2012), p.299

4.4.2 Effect of the “Subject to” tax clause

One could consider that the profit distribution made by a paying company, which has deducted the yield on hybrid instruments, is not covered by the Directive on the ground of the “subject to” tax clause in Art 2 (a)(iii) of the Directive. This Article states that company within the meaning of the Directive shall constitute any company, which is subject to one of the taxes listed in Annex I, Part B, without the possibility of an option or of being exempt. Therefore, tax-exempt entities do not come under the scope of application of the directive.¹²⁸

One could argue that the distributed profits would not effectively be subject to tax since deductibility of the yield on hybrid instruments can economically be seen as a credit of the taxes paid on these profits when they were earned.¹²⁹ However, this argument cannot be considered to be in line with the “subject to” tax clause, as this clause requires not profit to be subject to tax, but rather the distributing company.¹³⁰ It is implied that the company in principle is subject to tax in the source state, irrespective of the level of taxation, even though in practice no taxes would be paid for example because of a loss year or because of another reason.¹³¹ And although the deduction reduces the overall tax liability, it does not mean that the company is exempt from company tax.¹³²

4.4.3 “Association” requirement

Benefits of the Parent-Subsidiary Directive are applicable “[w]here a parent company or its permanent establishment, by virtue of the association of the parent company with its subsidiary, receives distributed profits...”¹³³. In the tax literature it is argued that insofar as hybrid instrument do not involve company law participation¹³⁴, the Parent-Subsidiary Directive do not cover these forms. It is based on the understanding that the profit distributions shall be linked to a participation of the receiving company in the issued share capital of the distributing company.¹³⁵

* * *

It can be inferred that the current wording of the Parent-Subsidiary Directive does not provide an effective solution on how to exclude from its scope the hybrid financial instruments, which give rise to unintended double non-taxation. It could be concluded that only arrangements, which constitute abusive practices, could be legitimately excluded. The Parent-Subsidiary Directive does not also cover hybrid instruments, which do not involve company law participation. Notably, that the latter form of hybrid instruments will still not be covered by the amendment to the Art 4(1) of the Directive.

4.5 Amendment as a platform for domestic anti-hybrid rules

Some EU countries have already implemented anti-hybrid rules, which deny dividend participation when the correspondent payment has been deducted by a source state.¹³⁶ OECD

¹²⁸ M. Helminen, ‘EU Tax Law – Direct Taxation’ (IBFD 2013), Online Books IBFD section 3.1.2.4

¹²⁹ Ch. Marchgraber, ‘Tackling Deduction and Non-Inclusion Schemes – The proposal of the European Commission’, *European Taxation* Vol.54, No 4 (2014), p.138

¹³⁰ Ibid.

¹³¹ M. Helminen (*n* 128)

¹³² J. Bundgaard, ‘Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives –Part 2’, *European Taxation*, Vol.50, No 11 (2010), p.496

¹³³ Parent-Subsidiary Directive, Article 4(1)

¹³⁴ for example, jouissance rights

¹³⁵ Ch. Marchgraber (*n* 129) p.139, footnotes omitted

¹³⁶ Denmark, Germany, Italy, Austria, United Kingdom have introduces such rules Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues, OECD (2012), p.18

BEPS Action Plan¹³⁷ also calls Member States to implement “linking rules” in order to neutralize the effect of hybrid mismatch. In this respect, the scholars have raised the question if these rules are compatible with the current version of the Directive. It is not aimed to analyze the issue of compatibility in details, however, it is noteworthy that the general opinion reached is that domestic anti-hybrid rules are in conflict with the current wording of the Directive as they are not fit in the exemptions prescribed by it.¹³⁸ In this way, the amendment of the Directive will ensure compliance of domestic rules with the secondary EU law.

The next Chapter proceeds to consider whether the amendment to the Article 4(1) of the Parent-Subsidiary Directive will collide with the fundamental freedoms.

5. COMPATIBILITY WITH EU LAW

5.1 General Remarks

It is assumed that “measures of the Community institutions are in principle presumed to be lawful”.¹³⁹ However, when secondary EU law is in conflict with the treaty freedoms, it should be set aside, but the actual cases challenge national implementing legislation.¹⁴⁰ Therefore, options granted by the Parent-Subsidiary Directive do not grant immunity to the domestic law that exercises such option.¹⁴¹ Following *Ouzo*, for reasons of legal certainty, secondary law may be invalidated only in “quite extreme situations”.¹⁴²

To this end, if the amendment of the Parent-Subsidiary Directive is adopted, domestic law, which will deny dividend participation exemption on the grounds of deductibility of the correspondent payment in a payer’s Member State, must be implemented in accordance with, *inter alia*, the fundamental freedoms, thereby avoiding any discrimination in respect of cross-border situations compared to domestic settings.

Moreover, the principle of equal treatment based on consistent and well-established case law requires equal situations to be treated equally. In order to assess whether the principle has been complied with, the ECJ has developed a number of tests. The first step includes the *comparability test* in order to establish whether the situations are comparable. The next step is to verify whether the distinction in treatment (if any) is reasonable, which implies the *justification test*. And in the end, the *proportionality test* shall be held. If a tax rule passes these tests, there is no prohibited discrimination.¹⁴³

Before proceeding to the compatibility analysis, it is intended to raise the question whether a taxpayer can actually suffer from the application of “linking rule”, secured by the amendment of the Parent-Subsidiary Directive.

¹³⁷ Action Plan on BEPS, OECD (2013)

¹³⁸ S. Kudert & C. Kahlenberg, ‘Extension of the Domestic Correspondence Principle’, *European Taxation*, Vol.54, No 1 (2014), p.44; Ch. Marchgraber (*n 129*) p.139

¹³⁹ Case C-475/01 *Commission of the European Communities supported by United Kingdom of Great Britain and Northern Ireland v. Hellenic Republic (Ouzo)* [2004] ECR I-08923, para 18

¹⁴⁰ K. Lozev & L. Gerzova, ‘Report on the Amsterdam Seminar of the Group for Research on European and International Taxation (GREIT)’, *European Taxation*, Vol.49, No 12 (2009), p.603

¹⁴¹ Georg Kofler and Mario Tenore (*n 102*) pp.339-341

¹⁴² Case C-475/01 *Ouzo (n 139)* para 20

¹⁴³ Lieven A. Denys, ‘The ECJ Case Law on Cross-Border Dividends Revisited’, *European Taxation*, Vol.47, No 5 (2007), p.221

5.2 Impediments behind denying of the participation exemption

One could raise reasonable doubts under which conditions the “linking rule” could cause a disadvantage for a resident parent company in a cross-border situation in comparison with a domestic one. As the law stands now it could be even argued that a domestic transaction is in a less favorable situation, as the dividend payment is subject to the corporate tax whereas a cross-border transaction involving hybrid financial instrument escapes any corporate tax under “negative” classification conflict. To this end, the amendment of the Parent-Subsidiary Directive seeks to neutralize the tax effect of hybrid financial instruments mismatch as well as it presumes that in this way a cross-border situation and a domestic situation will be treated equally (see *Annex C, Figure 1*).

However, from the perspective of the group of companies, which includes non-resident subsidiaries, the additional tax burden might arise in comparison with a wholly domestic group. This especially holds true with a view to the different tax rates in Member States. For example, if the tax value of a deductible dividend is less than the tax value of the participation exemption.¹⁴⁴ Another example of the impediment includes economic double taxation. It arises when the lower corporate income tax rate is applicable in the state of a first-tier non-resident subsidiary, which treats the payment as deductible, while income is distributed by the second-tier subsidiary from the third country that treats payment as non-deductible and applies a tax rate higher than the one in the state of a first-tier subsidiary.¹⁴⁵ The example (see *Annex C, Figure 2 – Option A*) illustrates that in the situation described above the proposed amendment may result in additional tax burden since the tax paid by the second-tier subsidiary on the non-deductible distribution will not be taken into account by the parent company, which tax the payment on the ground of its deductibility by the first-tier subsidiary. It is worth mentioning that if the parent company switched to the credit method instead of full taxation (*Option B*), the economic double taxation would be prevented.

In the light of this example, it could be inferred that from the perspective of the group of companies, there is a possibility that the taxpayer could find himself in a less favourable situation compared with a domestic situation.

5.3 Applicable Freedom

It is settled case law that the tax treatment of dividends may fall within Article 49 TFEU on freedom of establishment and Article 63 TFEU on the free movement of capital.¹⁴⁶ Freedom of establishment would apply if the participation confers on the shareholder definite influence over the decisions of the company paying the dividends and allow him to determine the company’s activities.¹⁴⁷ Portfolio investments must be examined exclusively in light of the free movement of capital.¹⁴⁸ The same hold true for the third countries situation,¹⁴⁹ however the scope of the Parent-subsidiary Directive is limited to EU companies. If a national measure has restrictive effects on both the freedom of establishment and the free movement of capital, then the effect on the free movement of capital would have to be seen as an unavoidable

¹⁴⁴ J. Bundgaard, ‘Hybrid Financial Instruments and Primary EU Law – Part 1’, *European Taxation*, Vol.53, No 11 (2013), p.551

¹⁴⁵ Ch. Marchgraber (*n 129*) p.137

¹⁴⁶ joint cases C-436/08 and C-437/08 *Haribo* [2011] ECR I-00305 para 33; Case C-446/04 *Test Claimants in the FII Group Litigation* [2006] ECR I-11753, para 36

¹⁴⁷ Case C-35/11 *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue, The Commissioners for Her Majesty’s Revenue & Customs* [2012] (ECR not yet published), para 91

¹⁴⁸ *Ibid* para 92

¹⁴⁹ *Ibid* para 104

consequence of a restriction on freedom of establishment and would not justify an independent examination of that measure in the light of the free movement of capital.¹⁵⁰

The wording of the Parent-Subsidiary Directive establishes minimum 10% holding in the capital of a subsidiary for qualification to the Directive benefits,¹⁵¹ however leaves an option for the Member States to replace, by means of bilateral agreement, the criterion of the holding.¹⁵²

If the national rules make dividend exemption subject to the existence of a minimum shareholding of 10%, then one could question if this threshold could constitute definite influence. The ECJ found that holdings amounting to less than 10% of the latter's capital do not confer the ability to exert a definite influence on the companies' decisions and to determine their activities.¹⁵³ Similarly, the support that a 10% shareholding is a controlling shareholding within the meaning of the freedom of establishment can be found in the decision of the German Federal Fiscal Court.¹⁵⁴ Therefore, it is reasonable to conclude that if participation exemption is applied where a shareholding amounts to at least 10%, then denying of exemption shall be tested against freedom of establishment. With regard to portfolio investment (holdings of less than 10%), the right to free movement of capital shall be applicable.¹⁵⁵

Therefore, the way, in which the Directive is implemented into the national legislation, could define which freedom is applicable. For the purpose of this paper the further consideration will be held from the perspective of a standard requirement of 10% minimum shareholding and hence, in the light of freedom of establishment.

5.4 Existence of different comparable situations

According to the established case - law one could note that in order to establish the existence of a restriction the ECJ gives preference to the assessment on a standalone basis rather than from the perspective of a whole group.¹⁵⁶ As a result, the following discussion is taken from the perspective of a parent company alone.

5.4.1 Same treatment?

The linking rules do not refer explicitly to cross-border situations. However, it is unlikely that a mismatch in a qualification will arise in domestic context, thus one could infer that "the application of the matching principle is de facto limited to cross border situations".¹⁵⁷

For instance, in *Lankhorst-Hohorst*¹⁵⁸ the Finanzgericht contended that the rule at issue was not directly linked to nationality¹⁵⁹ and therefore, there was no less favourable treatment based on the residence of the shareholder. However, the Court established that

¹⁵⁰ Case C-31/11 Marianne Scheunemann v Finanzamt Bremerhaven (ECR not yet published), para 30

¹⁵¹ Parent-Subsidiary Directive, Article 3(1)(a)

¹⁵² Parent-Subsidiary Directive, Article 3(2)(a)

¹⁵³ Cases C-436/08 and C-437/08 Haribo Lakritzen Hans Riegel BetriebsgmbH (C-436/08), Österreichische Salinen AG (C-437/08) v Finanzamt Linz, para. 36

¹⁵⁴ O.Thömmes & A. Linn, 'The New German DCL and Dividend Matching Rules and EU Law', *Intertax*, Vol. 42, No 1 (2014), pp.32-33 citing BFH, 29 August 2012, I R 7/12, BStBl. II 2013, 89.

¹⁵⁵ S. Kudert & C. Kahlenberg (*n 138*) p.43

¹⁵⁶ Case C-311/08 *Société de Gestion Industrielle SA (SGI) v État belge* [2010] ECR 2010 I-00487, para 52; J. Bundgaard (2013) (*n 144*) pp.550-551

¹⁵⁷ O.Thömmes & A. Linn (*n 154*) p.33

¹⁵⁸ Case C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779

¹⁵⁹ *Ibid* para 22

notwithstanding that fact a German rule constituted restriction to the freedom of establishment.¹⁶⁰

On the other hand, one cannot but notice that in *Kerckhaert-Morres*¹⁶¹ the Court did not find that the Belgium tax law, resulted in juridical double taxation, amounted to restriction of the free movement of capital since the Belgian tax legislation did not make any distinction between dividends from companies established in Belgium and dividends from companies established in another Member State. Under Belgian law both were taxed at an identical rate of 25% by way of income tax.¹⁶² It is noteworthy, that the ECJ's decision has been found disappointing from an Internal Market perspective, and it was subject to criticism on multiple levels.¹⁶³

*Columbus Container*¹⁶⁴ has a significant resemblance to *Kerckhaert-Morres*¹⁶⁵. The German case dealt with the switch over from the exemption to the credit method in case of a hybrid entity with a low taxation in Belgium, the Court also found that the legislation at issue did not constitute tax disadvantage for a non-resident partnership in comparison with domestic partnerships and consequently, there was no discrimination resulting from a difference in treatment between those two categories of partnerships.¹⁶⁶ Despite the fact that the replacement of the exemption method by the set-off method increased the tax burden of partners by 53%¹⁶⁷, the Court stated that the legislation merely subjected, in Germany, the profits made by such partnerships to the same tax rate as profits made by partnerships established in Germany.¹⁶⁸

On the one hand, the line of reasoning based on the above two cases could be invoked by analogy. It is assumed that by denying the participation exemption the distributed income at the level of a parent company would be subject to the same tax rate as the dividends in a domestic situation.

However, it is required to lay emphasis on the fact that exemption was not merely denied, but was substituted by the credit method. "Trading results" of the partnership were taxed in full in Germany, although Tax Office did offset the amount of tax paid on the amount in Belgium.¹⁶⁹ This gives reason to imply that had the resident state switched from the exemption method to the credit method in relation to the profit distribution, deductible for the tax purposes in the source state, such rules would have stood for better chances to be in compliance with the EU law. It is unlikely, however, that all Member states would agree to refrain from the exemption method in favor of the credit method in order to tackle double non-taxation in case of asymmetrical classification.¹⁷⁰

¹⁶⁰ Ibid para 27

¹⁶¹ Case C-513/04 *Mark Kerckhaert and Bernadette Morres v. Belgische Staat* [2006] ECR I-10967

¹⁶² Ibid para 17

¹⁶³ G. Kofler & R. Mason, 'Double Taxation: A European "Switch in Time?"', *Columbia Journal of European Law*, Vol.14 (2007), p.79

¹⁶⁴ Case No. C-298/05 *Columbus Container* (n 87)

¹⁶⁵ Gerard T.K. Meussen, 'Columbus Container Services – A Victory for the Member States' Fiscal Autonomy', *European Taxation*, Vol.48, No 4 (2008), p.171

¹⁶⁶ Case C-298/05, *Columbus Container* (n 87) para 40

¹⁶⁷ Ibid para 37

¹⁶⁸ Case C-298/05 *Columbus Container* (n 87) para 39

¹⁶⁹ Case C-298/05 *Columbus Container* (n 87), Opinion of AG Mengozzi, para 24

¹⁷⁰ Ch. Marchgraber (n 129) p.137, footnote 36

5.4.2 Case law on CFC rules

Noteworthy, that the Court's ruling in *Columbus Container* did not follow the way of reasoning in the AG's opinion, which was held along the lines of a decision on the basis of CFC legislation.¹⁷¹ On the other hand, it could be assumed that "the deductibility of dividends or deductibility of payments that are classified inconsistently due to the application of different principles in the domestic tax legislation of Member States is merely a subset of the deviations that may have caused a company to be considered a low-tax company under the applicable CFC legislation of many Member States".¹⁷²

If the Court would follow this line of reasoning, then it would be appropriate to compare a parent company owning a non-resident subsidiary, which treats the payments on hybrid instrument as interests, with a parent company owning non-resident subsidiary, which treats payment symmetrically. Thus, in the first case the participation exemption is denied, whereas in the second case the parent company enjoys the benefits of the Parent-Subsidiary Directive.

The counter-argument that "the disparity in the rates of corporation tax in effect within the Union constitutes an objective difference in situation justifying the differentiated treatment" was rejected¹⁷³.

It follows from the finding in *Eurowings Luftverkehr*¹⁷⁴ and *Barbier*¹⁷⁵, that low taxation applicable in a Member State cannot justify unfavourable tax treatment by another Member State and a Community national cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence.¹⁷⁶ To this end, one could expect that the deductibility of the payments at level of the paying company cannot constitute the relevant characteristic for making two situations incomparable.

The paper now proceeds to consider the case law specifically on inbound dividends in terms of comparability of resident shareholders depending on the residence of their subsidiaries.

5.4.3 Case law on inbound dividends

In *Lenz*¹⁷⁷ the Court found that Austrian shareholder who received revenue from capital from a company established in another Member state was in comparable situation with an Austrian shareholder who received dividends from Austrian companies. The comparability was established in the context of a tax rule designed to attenuate the effects of double taxation.¹⁷⁸ The common characteristic of two situations was the capability of being subject to double taxation.

However, the situation of fully taxable entities might differ according to the place where they invested their capital. For instance, "the Member State in which the investments were made

¹⁷¹ Gerard T.K.Meussen (*n 165*) p.172

¹⁷² J. Bundgaard (2013) (*n 144*) p.552

¹⁷³ Case C-196/04 *Cadbury Schweppes* (*n 22*), Opinion of AG Léger, para 79; Case C-196/04 *Cadbury Schweppes* (*n 22*) para 49

¹⁷⁴ Case C-294/97 *Eurowings Luftverkehrs AG and Finanzamt Dortmund-Unna* [1999] ECR I-07447, para 44

¹⁷⁵ Case C 364/01 *The heirs of H. Barbier and Inspecteur van de Belastingdienst Particulieren/Ondernemingen buitenland te Heerlen* [2003] ECR I-15013, para 71

¹⁷⁶ Case C-196/04 *Cadbury Schweppes* (*n 22*), Opinion of AG Léger, para 82; Case C-196/04 *Cadbury Schweppes* (*n 22*) para 49

¹⁷⁷ Case C-315/02 *Anneliese Lenz v Finanzlandesdirektion für Tirol* [2004] ECR I-07063

¹⁷⁸ *Ibid* para.30-32

already eliminated the risk of double taxation of company profits distributed in the form of dividends, by, for example, subjecting to corporation tax only such profits by the company concerned as were not distributed”.¹⁷⁹ As a corollary, if the tax rules of a source state eliminate the risk of double taxation, the situations are not longer comparable with a view that the common characteristic disappears.¹⁸⁰

As such, one could raise doubts on comparability of nationally-sourced dividends and foreign-sourced dividends, which have been subject to deduction in a source member state, on the ground that by deducting the yield on hybrid financial instruments a source state actually has eliminated double taxation.¹⁸¹ However, given that a source state eliminates double taxation not for dividends, but for interests, the question remains unclear whether this shall be regarded as if “the common characteristic disappears”.

5.4.4 Disparity

The lack of comparability could be established on the ground of the Court’s decision in *Schempp*¹⁸². The dispute in that case was whether Mr. Shempp, a resident in Germany, could deduct the alimony payment made to his former spouse, who was a resident in Austria. German law, in case of alimony payment to non-residents, made the deduction conditional on the alimony being taxed in the Member State of the recipient, however alimony was not taxable in general in Austria. With a view to the fact that unfavourable treatment was a consequence of a disparity in the tax law of the two Member States,¹⁸³ the Court held that the refusal to allow Mr. Schempp to deduct the payments made to his wife in Austria did not constitute discrimination, which infringed Article 12 EC (now Article 18 of the TFEU).¹⁸⁴

This finding could have an impact on the comparability analysis. The national rule, which denies dividend exemption to a resident parent company in a cross border situation, could be immunized from the non-discriminatory provisions laid down in TFEU by linking it to the tax treatment of the correspondent payment in a source Member State.

* * *

It seems hard to safely conclude if the national rule based on the proposed amendment of the Article 4(1)(a) of the Parent-Subsidiary Directive will pass the comparability test. It likely depends on the factor, which the Court would choose in order to form the backbone of the common characteristic for two situations.

Consideration of the scholars’ debate in relation to the comparability of domestic anti-hybrid rules with the EU law has shown that the general conclusion is that the rule in question will result in less favourable treatment of the recipient of the payment if the payer is a non-resident¹⁸⁵ and application of this rule likely violates the fundamental freedoms¹⁸⁶. Particularly, it is feasible given the possibility of economic double taxation.

5.5 Possible justification

According to the settled case-law, a restriction of freedom of establishment is permissible only if it is justified by overriding reasons in the public interest. It is further necessary, in such

¹⁷⁹ Case C-319/02 *Manninen* (n 101) para 34

¹⁸⁰ Niels Bammens, *The principle of Non-Discrimination in International and European Tax Law*, Vol.24 IBFD Doctoral Series (2012), p.730

¹⁸¹ see to this effect J. Bundgaard (2013) (n 144) p.551

¹⁸² C-403/03 *Egon Schempp v. Finanzamt München* [2005] ECR I-6421

¹⁸³ *Ibid* para 32

¹⁸⁴ *Ibid* para 36

¹⁸⁵ O. Thömmes & A. Linn (n 154) p.33

¹⁸⁶ J. Bundgaard (2013) (n 144) p.552

a case, that it should be appropriate to ensuring the attainment of the objective in question and not go beyond what is necessary to attain that objective.¹⁸⁷

5.5.1 Unacceptable justifications

The idea behind the proposed amendment is not only to establish a level playing field, but also to reduce the loss of tax revenue. However, it is established case-law that the loss of tax revenue does not constitute an overriding reason in the public interest which may justify a measure which is in principle contrary to the fundamental freedom.¹⁸⁸

Similarly, counteracting harmful tax competition as an objective of the rules cannot be accepted in order to justify a restriction on freedom of establishment. It may constitute a matter of a political nature and therefore has no effect on the rights and obligations of Member States under the Treaty.¹⁸⁹ To that end, other justifications will be considered further.

5.5.2 Prevention of tax avoidance

The Court has consistently held that the prevention of tax avoidance may be relied upon to justify restrictions on the exercise of fundamental freedoms guaranteed by the Treaty. However, a general presumption of tax avoidance or fraud is not sufficient to justify a fiscal measure, which compromises the objectives of the Treaty.¹⁹⁰

In *Cadbury Schweppes*¹⁹¹ the ECJ stated that the fact that the taxpayer sought to profit from tax advantages in force in a Member State other than his own couldn't in itself deprive the taxpayer of the right to rely on the provisions of the treaty.¹⁹² And as to the freedom of establishment, the fact that a company was established in a Member State for the purpose of benefiting from more favourable legislation does not in itself suffice to constitute abuse of that freedom.¹⁹³ The Court clarified that in order for a restrictive measure to be justified on the ground of prevention of abusive practices, it must "specifically relate[s] to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned and "the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory".¹⁹⁴

Further clarification on the tax avoidance test could be based on the findings in *Test Claimants in the Thin Cap Group Litigation*¹⁹⁵ on thin capitalization legislation, which is deemed to be relevant with a view that a nature of hybrid finance includes debt. ECJ ruled out that the legislation at issue was justified on the grounds based on the fight against abusive practices. However, in order for the legislation at issue to be proportionate 1) the taxpayers shall be allowed to produce evidence without undue administrative constraints as to the

¹⁸⁷ Case C-446/03 *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* [2005] ECR

I-10837, para 35; Case C-196/04 *Cadbury Schweppes (n 22)* para 47; Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* [2007] ECR I-02107, para 64

¹⁸⁸ Case C-264/96 *ICI* [1998] ECR I-4695, para 28; Case C-307/97 *Saint-Gobain ZN* [1999] ECR I-6161, para 51

¹⁸⁹ Case C-298/05 *Columbus Container (n 87)*, Opinion of AG Mengozzi, paras 163-165

¹⁹⁰ Case C-334/02 *Commission of the European Communities v. France*, [2004] ECR I-2229, para 27 with cited cases

¹⁹¹ Case C-196/04 *Cadbury Schweppes (n 22)*

¹⁹² *Ibid* para 36

¹⁹³ *Ibid* para 37; Case C-212/97 *Centros Ltd and Erhvervsog Selskabsstyrelsen* [1999] ECR I-01459, para 27; Case C-167/01 *Inspire Art* [2003] ECR I-10155, para 96

¹⁹⁴ Case C-196/04 *Cadbury Schweppes (n 22)* paras 51,55

¹⁹⁵ Case C-524/04 *Test Claimants in the Thin Cap Group Litigation (n 187)*

commercial justification for the transaction in question¹⁹⁶ and 2) where the transaction represents a purely artificial arrangement, reclassification of interests is limited to the proportion of the amount that exceeds arm's length.¹⁹⁷

Follow this decision, it could be reasonably expected that once the company is able to provide evidence of the commercial reasons for the transactions and the terms of the involved hybrid financial instruments are at arm's length, there will not be an abusive tax practice.¹⁹⁸

However, the general assumption that financing through hybrid financial instruments constitutes abuse of the fundamental freedom seems to be incorrect, unless this structure reflects genuine economic activity. This finds support in a recent case law of the Dutch Supreme Court concerning treatment of hybrid financial instruments for participation exemption purposes. The issue concerned a Dutch company, which refinanced its subsidiary in Australia by converting a loan to the subsidiary into redeemable preference shares (RPS) in the subsidiary. The issue in that case was whether the participation exemption should apply to income distributed on the RPS, taking into account the fact that RPS were tax deductible in Australia. One of the arguments put forward by the tax authorities was abuse of tax law. However, the Court made it clear that taxpayers were free to choose the form in which to finance their subsidiaries, taking into account the intent of the participation exemption.¹⁹⁹

To this end, one could expect that the rules, which do not target wholly artificial arrangements, but applied automatically, are not capable to justify the restriction of the freedom of establishment as it was in *Lankhorst-Hohorst*.²⁰⁰

By contrast, in *SGI*²⁰¹ the Court evolved its jurisprudence on abuse of law doctrine. The case was related to the transfer pricing rules, which resulted in economic double taxation. The Court's decision demonstrates that in order for a Member State retain tax rules that constitute restriction on the freedom of establishment and treats cross-border situation less favourably compared to the domestic situation, the ones should not obligatory target wholly artificially arrangements. The justification for such rules could be based on the need to prevent tax avoidance "taken together with that of preserving the balanced allocation of the power to impose taxes between the Member States".²⁰²

Based on this, it should be further assessed, whether the balanced allocation of taxing rights could constitute part of the justification.

5.5.3 Balanced allocation of taxing rights

Accepted at first time in *Marks & Spencer*,²⁰³ however, in conjunction with prevention of double use of losses and the risk of tax avoidance, the balanced allocation between Member States of the power to tax became an independent justification in *X Holding*.²⁰⁴ With respect to this justification the Court stated that it may be accepted "in particular, where the system in question is designed to prevent conduct capable of jeopardising the right of a Member State to

¹⁹⁶ Ibid para 82

¹⁹⁷ Ibid para 83

¹⁹⁸ Luc De Broe, 'Some Observations On The 2007 Communication From The Commission', *EC Tax Review*, Vol. 17, No 3 (2008), p.146

¹⁹⁹ see to this effect <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-netherlands-140214.pdf>; http://www.dlapiper.com/en/uk/insights/publications/2014/03/international-tax-news-march-2014/tax-treatment-of-hybrid-finance-instruments/#_ftnref7

²⁰⁰ Case C-324/00 *Lankhorst-Hohorst* (n 158) para 37

²⁰¹ Case C-311/08 *SGI* (n 156)

²⁰² ibid para.66

²⁰³ Case C-446/03 *Marks & Spencer* (n 187)

²⁰⁴ Case C-337/08 *X Holding v. Staatssecretaris van Financiën* [2010] ECR I-01215, para 33

exercise its tax jurisdiction in relation to activities carried out in its territory”²⁰⁵. However, unlikely that this justification is relevant for the linking rules, because the idea behind the latter is not to ensure the right to tax the activities carried out in the territory of the Member State.²⁰⁶

5.5.4 Prevention of “double dip”

The new proposal is aimed to clamp down on hybrid mismatch arrangements, which result in double non-taxation. Double non-taxation can be put on the same footing as the double use of losses because both are recognized forms of aggressive tax planning.²⁰⁷

The reason to prevent double use of losses has been accepted by the ECJ in order to justify the restrictive measure.²⁰⁸ However, this justification is always accompanied by another reason and based on ruling in *Philips Electronics*²⁰⁹, it could be concluded that the Court is reluctant to accept the objective to avoid double use of losses as an independent justification.²¹⁰

In addition, the counterargument to the application of double non-taxation as a safe justification could be based on the statement in *CIBA*²¹¹, that Member States are not obliged to adapt their own tax systems to the different systems of taxation of the other Member States in order, inter alia, to eliminate the double taxation arising from the exercise in parallel by those States of their fiscal sovereignty.²¹² Consequently, the Court concluded that the double taxation does not alone constitute a restriction prohibited by the Treaty.²¹³ To this end, one could raise the question why should the Court protect Member States from double non-taxation resulted from hybrid arrangements, but not protect taxpayers from Member States' double taxation of their profits? Arguably, neither is compatible with the Internal market.²¹⁴

On the other hand, as specified by Vanistendael “it is clear that to claim such a double deduction on the basis of the fundamental freedoms would be tantamount to the abuse of Community law. Such a double deduction would also violate the principle of neutrality characterizing the Single Market”.²¹⁵

5.5.5 Coherence of the tax system

Cohesion is something of a mysterious concept that is invoked very often by Member States to defend their tax systems, but has only rarely been accepted by the Court.²¹⁶ In respect of this justification AG Kokott observed that “[t]his rather diffuse concept ... generally means no more than avoiding double taxation or ensuring that income is actually taxed, but only once (the principle of only-once taxation).”²¹⁷ By the same token, one could notice that the aim of the proposed legislation change is to ensure the actual taxation of the payment made

²⁰⁵ Case C-446/03 *Marks & Spencer (n 187)* para 46; Case C-311/08 *SGI (n 156)* para 60

²⁰⁶ J. Bundgaard (2013) (*n 144*) p.589

²⁰⁷ C(2012)8806 final, at p.2

²⁰⁸ Case C-446/03 *Marks & Spencer (n 187)* paras 32, 34, 44 – 51.

²⁰⁹ Case C-18/11 *The Commissioners for Her Majesty's Revenue & Customs v Philips Electronics UK Ltd* [2012] ECR not yet published

²¹⁰ Ibid para 28

²¹¹ Case C-96/08 *CIBA Speciality Chemicals Central and Eastern Europe Szolgáltató, Tanácsadó és Kereskedelmi kft v Adó- és Pénzügyi Ellenőrzési Hivatal (APEH) Hatósági Főosztály* [2010] ECR I-02911

²¹² ibid para 28 and other cited cases

²¹³ ibid para 29

²¹⁴ G. Kofler & R. Mason (*n 163*) p. 81; Frans Vanistendael, ‘The ECJ at the Crossroads: Balancing Tax Sovereignty Against the Imperatives of the Single Market’, *European Taxation*, Vol.46, No 9 (2006), pp. 418-419; Ch. Marchgraber (*n 129*) p.140

²¹⁵ Frans Vanistendael (*n 209*) p. 416

²¹⁶ Niels Bammens (*n 180*) p.994

²¹⁷ Case C-319/02 *Manninen (n 101)*, Opinion of AG Kokott, para 51

under hybrid financial instrument, which is treated as tax deductible in a payer's state.

For the justification to be accepted by the Court it is required that there be a direct link “in the case of one and the same taxpayer, between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy, both of which related to the same tax”.²¹⁸ It could be argued that granting of dividend participation exemption refers to the pre-existing tax burden in a source Member State and if no pre-existing tax burden is present (advantage), denying of participation exemption can be seen as a way of off-setting of this advantage. To this end, cohesion is, at least, perceivable as a justification.²¹⁹

However, in *Bosal*²²⁰ the Court concluded that there was no direct link in the context of the same liability to tax because “parent companies and their subsidiaries are distinct legal persons, each being subject to a tax liability of its own”.²²¹ On the other hand, based on the decisions dealing with dividend distributions, such as *Commission v. Portugal*²²² and *Commission v. Germany*²²³, it has been observed that the Court evolved its perception of the coherence concept and no longer seems require existence of a direct link in the case of one and the same taxpayer.²²⁴

Before that AG Kokott also raised the question whether the criteria ‘one and the same taxpayer’ and ‘the same tax’ were binding and had to be both met, or whether they were only indicators – albeit strong ones – of the existence of a direct link between a tax advantage and disadvantage.²²⁵ In her reasoning in *Manninen* she deviated from the strictly legal point of view and interpreted the cohesion argument “from the point of view of the real effect of the tax rule in reducing double taxation even when the rule affects two different entities”²²⁶. One of the preconditions for this interpretation is that “the legal configuration of the system ensures that the advantage accrues to the one taxpayer only if the disadvantage to the other is real and *in the same amount*” (emphasis is added).²²⁷

Even had the argumentation, supported denying of participation exemption, evolved based on that interpretation, it would have been hard to imagine existence of the numerical link between the amount paid at the level of the parent company and tax value of the correspondent yield on hybrid financial instrument deducted at the level of the subsidiary due to the different tax rates in Member States.

Moreover, if the cohesion argumentation is based on the need to secure the principle of only-once taxation, then in order to be relied on it, the country rules should also solve the problem of double-taxation in the event of “positive” classification conflict. However, it seems that the possibility of double-taxation is generally ignored.²²⁸

* * *

Based on the above consideration it is doubtful that the presented justification will be capable

²¹⁸ Case 168/01 *Bosal* (n 104) para 29

²¹⁹ see, to this effect, S. Kudert & C. Kahlenberg (n 138) p.43

²²⁰ Case C-168/01 *Bosal* (n 104)

²²¹ *Ibid* para 32

²²² Case C-493/09 *European Commission v. Portuguese Republic* [2011] ECR I-09247

²²³ Case C-284/09 *Commission of the European Communities v. Federal Republic of Germany* [2011] ECR I-09879

²²⁴ see discussion G. Genta, ‘Dividends Received by Investment Funds: An EU Law Perspective – Part 2’, *European Taxation*, Vol.53, No 4 (2013), p.150

²²⁵ Case C-319/02 *Manninen* (n 101), Opinion of AG Kokott, para 55

²²⁶ F. Vanistendael, ‘Cohesion: the phoenix rises from his ashes’, *EC Tax Review*, No 4 (2005), p.218

²²⁷ Case C-319/02 *Manninen* (n 101), Opinion of AG Kokott, para 61

²²⁸ S. Kudert & C. Kahlenberg (n 138) pp.43-44

to justify the linking rule on an independent basis if the rule would be found restrictive. However, in order to ensure compliance with principles of tax neutrality and equality one could expect that the Court will elaborate on justification as prevention of “double dip” structures in combination with fight of abusive practices.

In the AG’s opinion in *OyAA*²²⁹, dealt with Finnish group taxation rules which precluded deduction of a transfer of profits made in favor of non-resident parent company, Kokott observed that actual taxation of income and prevention of tax avoidance could be achieved by a rule that makes the deductibility for tax purposes of an intra-group transfer conditional on proof that the income was in fact taxed in the hands of the recipient company.²³⁰ Interpreting the statement *vice versa*, i.e. making participation exemption for tax purposes conditional on proof that the income was in fact taxed at the hand of the distributing company, one could infer that the Court would find the linking rules justifiable. Another issue, however, is whether they would be found proportionate.

5.6 Proportionality Test

In order to fulfill the proportionality test the national rule should not go beyond what is necessary to achieve its purpose and aim. At the present stage of research it is hard to conclude safety on fulfillment of the proportionality test since it depends on the actual wording of the rule. In general, the ECJ does not endorse an automatic *prima facie* rejection of the benefit of the Parent-Subsidiary Directive, especially when the taxpayers are not entitled to provide evidence to the contrary.²³¹ To this end, two essential elements can be highlighted for the rule to be proportional:

- the rule shall provide for the possibility to the taxpayer to produce evidence on genuine economic context of the transaction and
- the rule shall take into consideration the possible taxation of lower-tier subsidiaries in order to avoid economic double taxation in compliance with the purpose of the Parent-Subsidiary Directive. But as the matter stands now, it is only foreseeable under the switch over to the credit method, that is, regrettably, not clarified by the proposed amendments.

6. CONCLUSION AND FINAL REMARKS

The purpose of this thesis was to assess whether the proposed amendment of the Parent-Subsidiary Directive, which contemplates to make participation exemption of the distributed profits conditional on the tax treatment of the correspondent payment in the source state, constitutes effective and comprehensive approach to tackle double non-taxation resulted from the “negative” classification conflict in relation to hybrid financial instruments.

As the starting point for the study, it has been discussed that the different tax treatment of dividend and interest, regardless its antilogy to the principle of equal treatment and principle of neutrality, is an inevitable “bias” at the present stage of EU law. In addition, lack of common standards as to the method of classification of the payments made under hybrid

²²⁹ Case C-231/05 *OyAA* [2007] ECR I-06373

²³⁰ Case C-231/05 *OyAA*, Opinion of AG Kokott, para 67

²³¹ M. Odar & B. Pate, ‘Taxation of Cross-Border Hidden Profit Distributions: (In)correct Implementation of the Parent-Subsidiary Directive in Slovenia?’, *European Taxation*, Vol.52, No 12 (2012), p.583

financial instruments exacerbates the issue of using these instruments in a tax planning tool kit.

Further, the analysis of the OECD Model demonstrates that there is no obligation for the resident state to accept the classification of the source state, however the resident state is affected by the result of such classification made by the source state. Until recently, the main focus of double tax treaties has been on elimination of (juridical) double taxation. The existing OECD Model does not explicitly refer to the problem of double non-taxation caused by the qualification conflict and as a result, does not provide the clear guidance in that regard. The Commentaries, although, clarify specific articles of the OECD Model as being capable to counter negative consequences of mismatches. But in general, the tax treaty qualification serves a very limited purpose, however, this in no way means that further international common standards to the effective and coherent approach to the mismatches problems shall not be developed.

Tax effect and handling of classification conflict under the Parent-Subsidiary Directive and the Interest and Royalty Directive are of greater interest. The main discussion among scholars is focused on the definition of the term “profit distribution”, or rather on its absence. The term, being one of the decisive factors, which assigns the benefits of the Parent-Subsidiary Directive to the EU companies, is not defined by the Directive. In the absence of the autonomous definition it is preferable for the ECJ to identify certain criteria for the national authorities to apply in the consistent way.

On the other hand, the Interest and Royalty Directive contains closed definition of interests and allows Member States to exclude certain types of hybrid debts from its scope, despite the fact that for domestic tax purposes the yield is still treated as interest. In such a way, the source state has the right to levy withholding tax. Following the amendment of the participation exemption provision in the Parent-Subsidiary Directive, there is a risk of arising of juridical double taxation, unless the allocation of taxing rights under the double tax treaty solves the issue.

It has been also revealed that neither of the considered Directives provides for reliable and exhaustive solution of the problem related to double taxation in case of “positive” classification conflict. This fact, in author’s opinion, undermines the Commission’s proposal to tackle double non-taxation to a great extent.

The Commission’s proposal seems also to disregard the fact that the power to tax the profit distribution with reference to the tax treatment of the correspondent payment only in the first-tier subsidiary could result in economic double taxation under certain circumstances. This result contradicts the objective of the Parent-Subsidiary Directive *per se*.

In the light of the foregoing, it could be expected that a taxpayer involved in the cross-border transactions related to hybrid financing would find himself in a less favourable situation than a taxpayer acting within one Member State. However, it is hard to conclude whether the ECJ would hold that the two situations comparable with a view to the various factors involved in determination of the common characteristic.

Important note is that tackling of classification mismatches does not fit in the concept of “abusive of law”. Mismatches arise in circumstances where there has been no attempt at tax manipulation and in this environment the suggestion that “every deduction must be matched by income somewhere is likely not only to catch avoidance but also sometimes the innocent”,²³² i.e. catch not only artificial arrangements but those, which constitute *bona fide*

²³² S. Edge, ‘Base Erosion and Profit Shifting: A Roadmap for Reform – Tax Arbitrage with Hybrid

transactions.

Other possible justifications were not found to be capable to immunize the denial of participation exemption rule on a stand-alone basis as well. On the other hand, it can be arguably assumed that the ECJ would develop a new combination of justifications in order to preclude double non-taxation as a hindrance, which violates the principles of tax neutrality and equality. But in the broader sense, amendment of the Parent-Subsidiary Directive alone contradicts with the principle of neutrality and the principle of fairness of tax system. Neutral tax system shall exclude double non-taxation but also double taxation.²³³

The author shares opinion that the proposal counters only the symptoms of unharmonized rules.²³⁴ The first public indications of suspicious attitude to the proposed amendment have already become evident.²³⁵

In consideration of the foregoing, a more balanced approach through the use of commonly accepted definitions, such as debt and equity for tax purposes, and harmonization of diverse classifying methods are considered to be a more effective ways for achieving a level playing field.

Instruments', *Bulletin for International Taxation*, Vol.68, No 6/7 (2014), Section 4

²³³ M. Cotrut, L. Gerzova & O. Popa, 'CFE Forum 2014: Policies for a Sustainable Tax Future', *European Taxation*, Vol.54, No 6 (2014), Sec.2.2.1

²³⁴ K. Dziurdź, "'Circularly Linked' Rules Countering Deduction and Non-Inclusion Schemes: Some Thoughts on a Tie-Breaker Test', *Bulletin for International Taxation*, Vol.67, No 6 (2013), p.310 citing M. Lang, "Aggressive Steuerplanung" – Eine Analyse der Empfehlung der Europäischen Kommission, 23 *Steuer und Wirtschaft International* 2, p. 62 (2013)

²³⁵ ECOFIN Press Release 9273/14 as of 6.05.2014

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/142513.pdf accessed 29.05.2014

Table 3.1 Ideal-typical rights and obligations of pure debt and pure equity

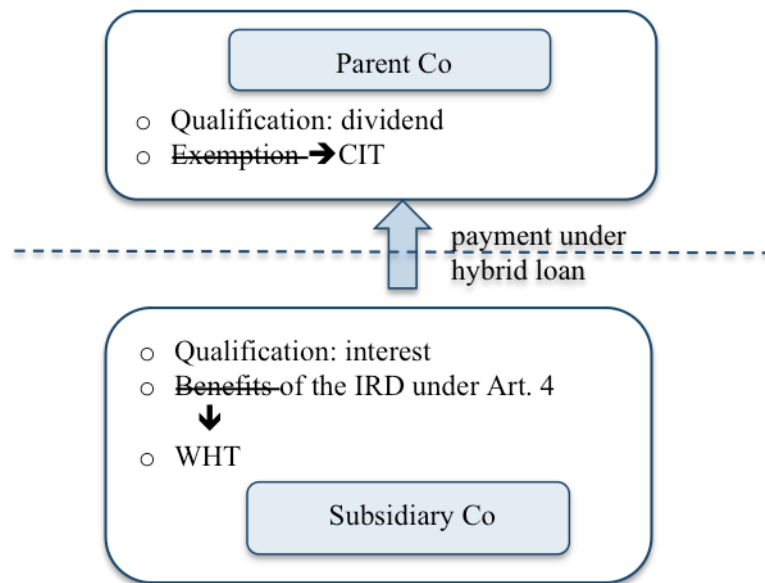
| Investor's rights and obligations | | | | Equity | Debt | |
|-----------------------------------|--|--------------------------|--------------------------------|-----------------------------------|------|---|
| Financial rights | Remuneration | Existence | Contingent (here: on profits) | ● | ○ | |
| | | | Fixed | ○ | ● | |
| | | Amount | Contingent (here: on profits) | ● | ○ | |
| | | | Fixed | ○ | ● | |
| | | Timing | Contingent (here: on decision) | ● | ○ | |
| | | | Fixed | ○ | ● | |
| | Repayment | Going concern | Existence | Contingent (here: on termination) | ○ | ● |
| | | | | Fixed | ○ | ● |
| | | Amount | Contingent | Market value of quota | / | ○ |
| | | | Fixed | Nominal value of capital | / | ● |
| | | Timing | Contingent | | ○ | ○ |
| | | | Fixed | | ○ | ● |
| Liquidation | Existence | Contingent on assets | Senior | ○ | ● | |
| | | | Junior | ● | ○ | |
| Amount | Contingent on assets | Market value of quota | ● | ○ | | |
| | | Nominal value of capital | ○ | ● | | |
| Non-financial rights | Right to control (voting power) | Going concern | | ● | ○ | |
| | | Liquidation | | ○ | ○ | |
| | Right for information | To be informed | | ● | ○ | |
| | | To request | | ● | ○ | |
| | Right to modify rights and obligations | Termination | Contingent | | ○ | ○ |
| | | | Fixed | | ○ | ○ |
| Conversion | Contingent | | – | – | | |
| | Fixed | | – | – | | |
| Obligations | Capital commitment | | ● | ● | | |
| | Acquiescence of the right to modify | Termination | ○ | ○ | | |
| | | Conversion | – | – | | |

● must apply, ○ may not apply, ○ may be the case, – is not decisive, / is not applicable

²³⁶ S. Bärsch (*n 4*) p.84

Annex B

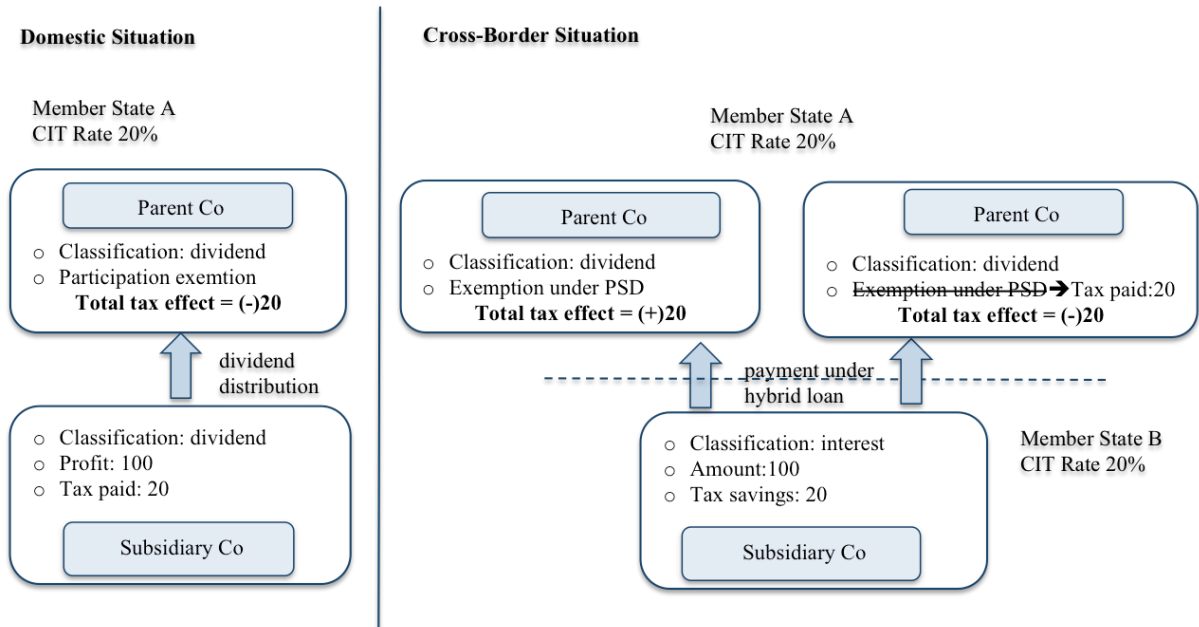
Figure 1



CIT – Corporate Income Tax
IRD – Interest and Royalties Directive
WHT – Withholding Tax

Annex C

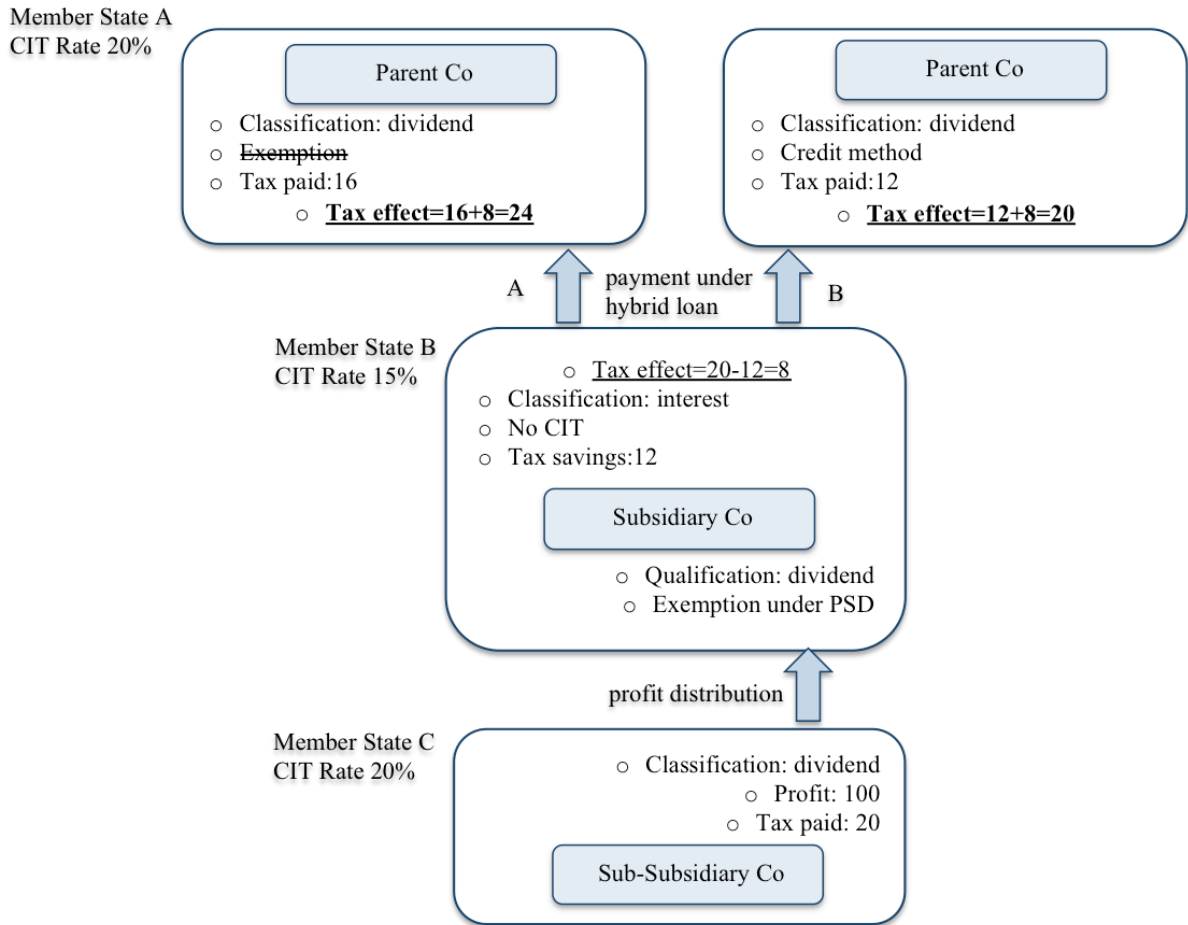
Figure 1



CIT – Corporate Income Tax

NB: the same tax rates are taken for simplicity in order to focus on the different tax effects between domestic and cross-border situation. The latter situation is also illustrated in terms of application of the current version of the PARENT-SUBSIDIARY DIRECTIVE and proposed amendment.

Figure 2



CIT – Corporate Income Tax

Bibliography

EU sources of law

Treaty on the Functioning of the European Union of 13 December 2007 [2008] OJ C115

Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2011] OJ L 345/8

Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States [2003] OJ L 157

Other EU Documents

Commission, 'Proposal for a COUNCIL DIRECTIVE amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States' COM(2013) 814 final

Commission, 'Communication from the Commission to the European Parliament and the Council – An Action Plan to strengthen the fight against tax fraud and tax evasion' COM (2012) 722

Commission, 'Summary report of the responses received on the public consultation on factual examples and possible ways to tackle double non-taxation cases' TAXUD D1 D(2012)

Commission, 'Commission Recommendation of 6.12.2012 on aggressive tax planning' C(2012) 8806 final

S. Fatica, T. Hemmelgarn, G. Nicodème, 'The Debt-Equity Tax Bias: consequences and solutions', Taxation Paper No 33 (2012)

http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_33_en.pdf

Commission, 'Tax Reforms in EU Member States 2011', *European Economy*, No 5 (2011)

European Commission, STATEMENT/14/92 dd 02/04/2014

Books

Bammens, N., *The principle of Non-Discrimination in International and European Tax Law*, Vol.24 IBFD Doctoral Series, 2012

Bärsch, S., *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context*, Springer-Verlag Berlin Heidelberg, 2012

Georg Kofler and Mario Tenore, 'Fundamental Freedoms and Directives in the Area of Direct Taxation', pp.311-360 in Dennis M. Weber, *Traditional and Alternative Routes to European Tax Integration*, IBFD, 2010

Helminen, M., *The Dividend Concept in International Tax Law: Dividend Payments Between Corporate Entities*, Kluwer Law International, 1999

Lang, M., *Tax Treaties: Building Bridges between Law and Economics*, IBFD, 2010

Pasquale Pistone, 'Soft Tax Law: Steering Legal Pluralism towards International Tax Coordination', p. 97-114 in Dennis M. Weber, '*Traditional and Alternative Routes to European Tax Integration*', IBFD (2010)

Russo, R., *Fundamentals of International Tax Planning*, IBFD, 2007

van Weeghel, S., 'Dividends (Article 10 OECD Model Convention)', pp.63-73 in Michael Lang, '*Source versus Residence*', Kluwer Law International BV, the Netherlands, 2008

Academic Articles

Avi-Yonah, R. S., 'Tax Competition, Tax Arbitrage, And The International Tax Regime', *Bulletin for International Taxation*, Vol. 61, No 4 (2007), pp.130-138

Bärsch, S. & Spengel, C., 'Hybrid Mismatch Arrangements: OECD Recommendations and German Practice', *Bulletin for International Taxation*, Vol.67, No 10 (2013), pp.520-528

Blessing, Peter H., 'The Debt-Equity Conundrum - A Prequel', *Bulletin for International Taxation*, Vol. 66, No 4/5 (2012), pp.198-212

Brokelind, C., 'Swedish Supreme Administrative Court Rejects Reference to ECJ Regarding Application of EC Parent-Subsidiary Directive', *European Taxation*, Vol.45, No 8 (2005), pp.323-330

Bundgaard, J., 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives –Part 1', *European Taxation*, Vol.50, No 10 (2010), pp.442-456

Bundgaard, J., 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 2', *European Taxation*, Vol.50, No 11 (2010), pp.490-500

Bundgaard, J., 'Hybrid Financial Instruments and Primary EU Law – Part 1', *European Taxation*, Vol.53, No 11 (2013), pp.539-554

Bundgaard, J., 'Hybrid Financial Instruments and Primary EU Law – Part 2', *European Taxation*, Vol.53, No 12 (2013), pp. 587-594

Christensen, Nathan R., 'The Case for Reviewing Debt/Equity Determinations for Abuse of Discretion', *University of Chicago Law Review*, Vol. 74, No 4 (2007), p.1309

Cotrut, M., Gerzova L. & Popa, O., 'CFE Forum 2014: Policies for a Sustainable Tax Future', *European Taxation*, Vol.54, No 6 (2014), pp.264-269

De Broe, L., 'Some Observations On The 2007 Communication From The Commission', *EC Tax Review*, Vol. 17, No 3 (2008), pp.142-148

Denys, L.A., 'The ECJ Case Law on Cross-Border Dividends Revisited', *European Taxation*, Vol.47, No 5 (2007), pp.221-238

Diritto E Pratica, Qualification Of Hybrid Financial Instruments In Tax Treaties

Distaso, M. & Russo, R., 'The EC Interest and Royalties Directive – A Comment', *European Taxation*, Vol. 44, No 4 (2004), pp.143-154

- Dziurdź, K., “Circularly Linked” Rules Countering Deduction and Non-Inclusion Schemes: Some Thoughts on a Tie-Breaker Test’, *Bulletin for International Taxation*, Vol.67, No 6 (2013), pp.306-310
- Edge, S., ‘OECD/United Kingdom - Base Erosion and Profit Shifting: A Roadmap for Reform – Tax Arbitrage with Hybrid Instruments’, *Bulletin for International Taxation*, Vol.68, No 6/7 (2014), next issue
- F.A.G. Prats, ‘Qualification Of Hybrid Financial Instruments In Tax Treaties’, *Diritto E Pratica Tributaria Internazionale*, Vol. VIII, No 3 (2011), pp.977-997
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2257065 accessed 10.04.2014
- Genta, G., ‘Dividends Received by Investment Funds: An EU Law Perspective – Part 2’, *European Taxation*, Vol.53, No 4 (2013), pp.141-157
- Helminen, M., ‘Classification of Cross-Border Payments on Hybrid Instruments’, *Bulletin for International Taxation*, Vol.58, No 2 (2004), pp.56-61
- Helminen, M., ‘Dividends, Interest and Royalties under the Nordic Multilateral Double Taxation Convention’, *Bulletin for International Taxation*, Vol. 61, No 2 (2007), pp.49-64
- Helminen, M., ‘The Problem of Double Non-Taxation in the European Union – To What Extent Could This Be Resolved through a Multilateral EU Tax Treaty Based on the Nordic Convention?’, *European Taxation*, Vol.53, No 7 (2013), pp.306-312
- Kofler, G. & Mason, R., ‘Double Taxation: A European “Switch in Time?”’, *Columbia Journal of European Law*, Vol.14 (2007), pp.63-98
- Kudert, S. & Kahlenberg, C., ‘Extension of the Domestic Correspondence Principle’, *European Taxation*, Vol.54, No 1 (2014), pp.40-44
- Law, S.B., ‘Anti-Avoidance Rules in Recent Tax Treaties’, *Bulletin for International Taxation*, Vol.66, No 6 (2012), pp.319-322
- Lozev, K. & Gerzova, L., ‘Report on the Amsterdam Seminar of the Group for Research on European and International Taxation (GREIT)’, *European Taxation*, Vol.49, No 12 (2009), pp.601-605
- Marchgraber, Ch., ‘Tackling Deduction and Non-Inclusion Schemes – The proposal of the European Commission’, *European Taxation* Vol.54, No 4 (2014), pp.133-142
- Meussen, Gerard T.K., ‘Columbus Container Services – A Victory for the Member States’ Fiscal Autonomy’, *European Taxation*, Vol.48, No 4 (2008), pp.169-173
- Odar, M. & Pate, B., ‘Taxation of Cross-Border Hidden Profit Distributions: (In)correct Implementation of the Parent-Subsidiary Directive in Slovenia?’, *European Taxation*, Vol.52, No 12 (2012), pp.579-583
- Schön, W., ‘The Distinct Equity of the Debt-Equity Distinction’, *Bulletin for International Taxation*, Vol.66, No 9 (2012), pp.490-502
- Schwarz, J., ‘Double Taxation in the European Single Market’, *Bulletin for International Taxation*, Vol.66, No 6 (2012), pp.295-299
- Thömmes, O. & Linn, A., ‘The New German DCL and Dividend Matching Rules and EU Law’, *Intertax*, Vol. 42, No 1 (2014), pp. 28-35
- Tomazela Santos, R., ‘Tax Treaty Qualification of Income Derived from Hybrid Financial Instruments’, *Bulletin for International Taxation*, Vol.67, No 10 (2013), pp.

Vanistendael, F., 'Cohesion: the phoenix rises from his ashes', *EC Tax Review*, No 4 (2005), pp.208-222

Vanistendael, F., 'The ECJ at the Crossroads: Balancing Tax Sovereignty Against the Imperatives of the Single Market', *European Taxation*, Vol.46, No 9 (2006), pp. 413-420

OECD Documents and Publications

Commentary to Model Tax Convention on Income and on Capital (2010)

Action Plan on Base Erosion and Profit Shifting (2013)

Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues (2012)

Public Discussion Draft: BEPS ACTION 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances 14 March 2014 – 9 April 2014, p.27 available at <http://www.oecd.org/ctp/treaties/treaty-abuse-discussion-draft-march-2014.pdf>

BIAC's comments received on public discussion draft BEPS ACTION 6: PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES 11 April 2014, p.2 available at <http://www.oecd.org/tax/treaties/comments-action-6-prevent-treaty-abuse.pdf>

Public Discussion Draft: BEPS ACTION 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws) 19 March 2014 – 2 May 2014

Web-Sites

http://www.belastingrechaandevu.nl/Portals/0/images/Boulogne_artikel20_Engels.pdf

<https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-netherlands-140214.pdf>;

http://www.dlapiper.com/en/uk/insights/publications/2014/03/international-tax-news-march-2014/tax-treatment-of-hybrid-finance-instruments/#_ftnref7

Miscellaneous

Connors, Peter J. & Woll, Glenn H.J., 'Hybrid Instruments – Current Issues' August (2001), p.1 <http://204.154.93.32/fileupload/5029.pdf> accessed 20.04.2014

Eberhartinger, Eva and Six, Martin (2006) National Tax Policy, the Directives and Hybrid Finance. Options for tax policy in the context of the treatment of Hybrid Financial Instruments in the Parent- Subsidiary Directive and the Interest and Royalties Directive. Discussion Papers SFB International Tax Coordination, 16. SFB International Tax Coordination, WU Vienna University of Economics and Business, Vienna

Eberhartinger, Eva and Six, Martin (2007) Taxation of Cross border Hybrid Finance. A legal Analysis. Discussion Papers SFB International Tax Coordination, 27. SFB International Tax Coordination, WU Vienna University of Economics and Business, Vienna

ECOFIN Press Release 9273/14 as of 6.05.2014

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/142513.pdf accessed 29.05.2014

Table of Cases

- Case C-138/07 *Belgische Staat v. Cobelfret NV* [2009] ECR I-00731
- Case C-231/05 *OyAA* [2007] ECR I-06373
- Case C-264/96 *ICI* [1998] ECR I-4695
- Case C-284/09 *Commission of the European Communities v. Federal Republic of Germany* [2011] ECR I-09879
- Case C-298/05, *Columbus Container Services BVBA & Co. v. Finanzamt Bielefeld-Innenstadt* [2007] ECR I-10451
- Case C-311/08 *Société de Gestion Industrielle SA (SGI) v. Belgian State* [2010] ECR I-00487
- Case C-315/02 *Anneliese Lenz v Finanzlandesdirektion für Tirol* [2004] ECR I-07063
- Case C-319/02 *Petri Manninen* [2004] ECR I-07477
- Case C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779
- Case C-337/08 *X Holding v. Staatssecretaris van Financiën* [2010] ECR I-01215
- Case C-403/03 *Egon Schempp v. Finanzamt München* [2005] ECR I-6421
- Case C-493/09 *European Commission v. Portuguese Republic* [2011] ECR I-09247
- Case C-513/04 *Mark Kerckhaert and Bernadette Morres v. Belgische Staat* [2006] ECR I-10967
- Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas* [2006] ECR I-7995
- Case C-247/08 *Gaz de France – Berliner Investissement SA v Bundeszentralamt für Steuern* [2009] ECR I-09225
- Case C-446/03 *Marks & Spencer* [2005] ECR I-10837
- Case C-524/04 *Test Claimants in the Thin Cap Group Litigation* [2007] ECR I-2107
- Case C-96/08 *CIBA Speciality Chemicals Central and Eastern Europe Szolgáltató, Tanácsadó és Kereskedelmi kft v Adó- és Pénzügyi Ellenőrzési Hivatal (APEH) Hatósági Főosztály* [2010] ECR I-02911
- Case C-168/01 *Bosal Holding BV v. Staatssecretaris van Financiën* [2003] ECR I-09409
- Case C-475/01 *Commission of the European Communities supported by United Kingdom of Great Britain and Northern Ireland v. Hellenic Republic* [2004] ECR I-08923