



Lund University

School of Economics and Management

Department of Business Law

**Linking Rules Assessed Against European and National
Legal Benchmarks**

A Juridical Remedy to Mitigate Double Non-Taxation?

By

Oliver Frank

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Examiner: Oskar Henkow

Supervisor: Cécile Brokelind

Author's contact information:

O_Frank@gmx.net

+49 151 23598158

Table of Contents

Summary	II
Preface	III
List of Abbreviations	IV
1 Introduction	1
1.1 Background	1
1.2 Aim	2
1.3 Method and Material	3
1.4 Delimitation	3
1.5 Outline	3
2 BEPS Action Plan 2	4
2.1 Linking Rules	6
2.1.1 Primary Rule.....	6
2.1.2 Secondary Rule.....	7
2.2 Underlying Principles of Source and Resident Taxation	9
2.2.1 Single Tax Principle and Neutrality.....	10
3 Linking Rule in Germany	10
3.1 Compliance with Domestic Law	11
3.2 Compliance with the OECD Recommendations	13
3.2.1 Treaty Override.....	14
3.3 Compliance with EU Law	15
3.3.1 Determination of the Applicable Freedom.....	16
3.3.2 Restriction of the Relevant Freedom.....	16
3.3.3 Justification of the Relevant Freedom.....	18
4 Linking Rules at the Benchmark of EU Law	20
4.1 Compliance of the Primary Rule with EU Law	20
4.1.1 Restriction of the Relevant Freedom.....	20
4.1.2 Justification of the Restriction.....	21
4.1.2.1 Coherence of the Tax System.....	21
4.1.2.2 Need to Prevent Tax Avoidance.....	22
4.2 Linking Rule in the Parent-Subsidiary Directive	23
4.2.1 In Light of the OECD Proposals.....	25
4.2.2 Impact on EU Law.....	26
4.3 The Benchmark of Anti-Avoidance Legislation	28
4.4 Nexus between OECD and EU	31
5 Alternative Remedies	32
5.1 CFC Legislation	33
5.2 State Aid	34
6 Final Remarks	34
Bibliography	i

Summary

Global enterprises are accused of eroding national tax bases by way of setting up aggressive tax schemes, which enabled them to dodge taxation on a large scale. In response to that, both the European Union and the OECD drafted several means to curb this harmful conduct.

This thesis provides a comprehensive analysis of linking rules, which were adapted as one of the alleged remedies against base erosion by the EU and the OECD. A number of issues emerge in connection with those recommended rules.

Clearly, the legal implications of measures proposed by the OECD are debatable, in contrast to EU Directives that imply legal binding force. This thesis will thus assess compliance of those rules against domestic and European legal benchmarks. German national law will serve as an example of domestic integration of those linking rules. Moreover, it discusses whether measures of this kind will eventually mitigate base erosion and double non-taxation and if so, what are their benefits/drawbacks in comparison to already existing juridical tools.

Following an in-depth analysis of these recommendations, this thesis reveals that linking rules as proposed by the OECD will in all likelihood infringe EU law. Likewise, the new linking rule of the Parent-Subsidiary Directive bears in itself certain risk to be found to violate EU law. Furthermore, these rules do arguably disqualify as anti-avoidance measures, as they do not take account of well-established principles in this field.

For these reasons and the various drawbacks, which are inherent in the linking rules, the thesis demonstrates that already existing legal means, such as CFC rules and State-Aid proceedings might also be auspicious to mitigate base erosion and double non-taxation.

Preface

Acknowledgement

I would like to express my gratitude to all the professors and lecturers in Lund who provided deep insights and shared their great expertise during this one-year programme.

I would also like to thank all my friends and my family, without whom I scarcely dared to venture this step. Thank you, for all your patience and your faith in me.

It is very well appreciated.

As a final statement and in the context of this thesis, I would like to cite Charles de Montesquieu, who once said; “Useless laws weaken the necessary laws” which was then as true as it is today.

List of Abbreviations

AG	Advocate General
AO	Abgabenordnung (German Fiscal Code)
BEPS	Base Erosion and Profit Shifting
BFH	Bundesfinanzhof (Supreme Financial Court)
CEN	Capital Export Neutrality
CFC	Controlled Foreign Company
CIN	Capital Import Neutrality
CIT	Corporate Income Tax
D/NI	Deduction/No-Inclusion
ECJ	Court of Justice of the European Union
EU	European Union
G20	Group of 20
GAAR	General Anti Avoidance Regulation
SAAR	Specific Anti Avoidance Regulation
KStG	Körperschaftsteuergesetz (German Corporate Tax)
MC	Model Convention
MNE	Multi-National Enterprise
OECD	Organisation for Economic Co-operation and Development
PSD	Parent-Subsidiary Directive
TFEU	Treaty on the Functioning of the European Union
US	United States of America

1 Introduction

1.1 Background

Global enterprises, such as Apple, Starbucks and Amazon are rebuked for paying almost zero taxes on their business profits by virtue of setting up innovative cross-border tax arrangements.¹ Such conduct is particularly accessible to Multi-national enterprises (MNEs) and is not only alleged to erode national tax bases² but also to distort competition and to place domestic companies at a disadvantage.³ The European Union (EU) suffers an estimated loss of some one trillion Euros every year, which is also a potential threat to fair taxation.⁴

As an inevitable consequence thereof and due to high political pressure, the Group of 20 (G20) summoned the Organisation for Economic Co-operation and Development (OECD) to unfold forceful remedies designed to protect national tax bases and to mitigate base erosion. On that account, the OECD called its Base Erosion and Profit Shifting (BEPS) project into existence. 6 “key pressure areas” were discovered and translated into 15 actions, whereby each of these actions will be subject to a comprehensive report. On EU level, the Commission did also release an Action Plan to strengthen the fight against tax fraud and tax evasion.⁵

Both the EU and the OECD identified hybrid financial instruments as one of the key issues in their endeavour to fight base erosion. Hybrid mismatch arrangements trigger double non-taxation and reside at the very core of international tax planning activities. Therefore, both the OECD and the EU advocate linking rules to counter mismatch arrangements in order to establish international coherence in taxation. Nonetheless, they pursue their aims in various ways, which facilitates legal pluralism.⁶ While the EU did include a linking rule in its Parent-Subsidiary Directive (PSD), the OECD proposed a set of two linking rules for domestic legal systems.

Evidently, the issues of double non-taxation and base erosion are on the radar of different organisations and institutions, where some of them are not even legally empowered.

In response to that, the question arises, what are the legal consequences (if any) of these recommendations on different legal benchmarks?

¹ C. Fuest, et. al., Profit Shifting and “Aggressive” Tax Planning by Multinational Firms: Issues and Options for Reform, 2013, p. 307.

² OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 31.

³ A. P. Dourado, Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6, 2015, p. 44.

⁴ European Commission, Press Release, 2012.

⁵ European Commission, COM(2012) 722 final.

⁶ Compare: P.Pistone, Soft Tax Law: Steering Legal Pluralism towards International Tax Coordination, 2010, p. 99.

Incidentally, one may appreciate the fact that double non-taxation is not only a result of tax planning, but also an intended incentive granted by certain states to attract foreign investments.⁷

1.2 Aim

In light of the foregoing a significant number of issues arises. Initially, it is beyond doubt that provisions advised by the OECD are merely regarded as soft law⁸ instruments and do therefore not entail any legal force whatsoever. Yet, at the very moment, in which a state relies on these proposals and introduces them into its domestic legal system, they acquire legal force. On the contrary, a linking rule as adopted in the Parent-Subsidiary Directive will eventually obtain legal force to EU Member States.

As its main issue, the thesis is thus aimed to assess linking rules against European and domestic legal benchmarks. In response thereto, the author wants to observe if those rules, albeit already introduced in secondary EU law, could still infringe EU law. As regards national law, this thesis will rely on German law as an example of domestic integration of linking rules. Aside from legal compliance issues, focus will also be drawn on whether linking rules are capable to pursue their intended aim, which is to counter double non-taxation, compared to already existing legal tools.

This thesis will reveal that there remain major discrepancies between the rules recommended by the EU and the OECD. The notion of reciprocal⁹ conformity is thus not exactly accurate.

For reasons that will be seen below, linking rules as proposed by the OECD are very likely to jeopardize the EU fundamental freedoms, if adopted unchanged into domestic law. Notwithstanding, they would need to be highly sophisticated and applied unanimously by all states to achieve their intended purpose to mitigate double non-taxation.

Moreover, it will be demonstrated that there is also a risk – albeit diminished – that the linking rule in the PSD may infringe primary EU law.

As a corollary, while there are several drawbacks inherent in the linking rules, other legal remedies, such as controlled foreign company rules (CFC) and state aid measures may prove capable to mitigate base erosion via hybrid instruments.

⁷ M. Gilleard, In search of harmony: Finding a consensus on hybrid mismatches. *International Tax Review*, Jul2014, Vol. 25, Issue 5.

⁸ S. Douma, *Leal Research in International and EU Tax Law*, 2014, p. 21.

⁹ A. P. Dourado, *Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6*, 2015, p. 51.

1.3 Method and Material

Since the work at hand covers manifold issues of law not only in a domestic context but also from an international angle, different methodological approaches have to be applied.

Thus, the following reflections will *inter alia* comprise an internal perspective, which illuminates the topic from a legal viewpoint. This part of the analysis is pivotal to analyse the law as it positively stands, which will become decisive in the inquiry of recommended legislation by the OECD, EU or domestic law provisions respectively.¹⁰ Problem solving, interpretative comments and description of the positive law will therefore form part of the analysis, too.¹¹ On the same token, it will be scrutinized if and how these new rules may fit into the existing framework of international and domestic legal benchmarks.

Extending beyond, focus will be drawn to the external perspective. This is in particular true as the thesis on hand discusses different sources of law such as primary and secondary EU law, domestic law and soft law instruments. Although the Court of Justice of the European Union (ECJ) did not yet render a judgment in respect of the proposed linking rules, the consecutive analysis relies essentially on doctrinal articles and comparable case law, which will be complemented by relevant opinions of the Advocate Generals (AG).

1.4 Delimitation

The issues arising around hybrid mismatches are sheer tremendous. Hybrid mismatches occur in a number of situations not only as a corollary of different treatment of financial instruments but also emerging from different treatment of corporate forms in cross-border situations, such as opaque and transparent enterprises or hybrid transfers and repos. Additionally, in dogmatic debates, different approaches for potential remedies exist. General Anti Avoidance Rules (GAARs), amendments of the Model Convention (MC), CFC rules and Thin-Cap provisions are counted among those. These previously mentioned approaches do rather play a peripheral role in the consecutive analysis, though. Instead, the subsequent work will illuminate the demanding issues arising in the context of linking rules as means to counter hybrid financial instruments, based on domestic and European law. Political affairs will also be left out of consideration.

1.5 Outline

In the author's view, a chronological approach to the subject at issue is most reasonable in pursuance of the intended goal to assess linking rules against domestic and international legislative benchmarks and in context of their pursued

¹⁰ S. Douma, *Leal Research in International and EU Tax Law*, 2014, p. 17.

¹¹ S. Douma, *Leal Research in International and EU Tax Law*, 2014, p. 18.

aim. The thesis is thus based on a “cause and effect”-pattern, which establishes the existence of the problem and then clarifies problematic areas.¹²

On that note, the author will at first place elaborate on the OECD-related recommendations to fight base erosion due to hybrid mismatch arrangements. Since the proposed measures require well-founded knowledge of general principles such as source and residence taxation, this chapter will also include a brief introduction to those international taxation principles. In Chapter 3, the author will discuss the impact of linking rules in a national context. Focus will be drawn on the recently applied linking rules in Germany's domestic law. Subsequently, Chapter 4 is devoted to EU law and in particular to the 2015 amendments of the Parent-Subsidiary Directive, which does now comprise a linking rule. Chapter 5 will eventually focus on other possible remedies, which might also be capable to mitigate double non-taxation and base erosion.

2 BEPS Action Plan 2

In order to protect national tax bases, the BEPS Action Plan is aimed to ensure that profits are taxed where economic activities generating the profits are performed and where value is created.¹³ As lately as of September 2014, the OECD did publish its Action 2 Deliverable on neutralising the effects of hybrid mismatch arrangements as another building block of the BEPS project.¹⁴ The main point of concern in the area of hybrid mismatch arrangements is tied to the issue of double non-taxation.¹⁵

To clarify what actually embodies a hybrid instrument and how those operate, the consecutive elaboration will provide some paradigms of potential hybrid instruments. In plain terms, hybrid mismatches are largely the outcome of different qualifications of debt and equity in cross-border situations between at least two different jurisdictions.¹⁶

The OECD Deliverable defines Hybrid mismatch arrangements as:

“An arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement.”¹⁷

¹² M. McKerchar, *Design and Conduct of Research in Tax, Law and Accounting*, 2010, p. 50.

¹³ OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Foreword.

¹⁴ OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.

¹⁵ E. C. Millán, M. S.-Roch, *Limit Base Erosion via Interest Deduction & Others*, 2015, p. 58.

¹⁶ OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 34.

¹⁷ *Ibid.*, Ch. 1, 2014.

Debt financing generally transfers the taxing rights from the source state to the residence state, while equity is rather taxed in the source state.¹⁸ The spectrum of those instruments ranges from loan-like corporate shares to loans with features typically associated with equity instruments.¹⁹ But what is the effect on tax base?

If a company in State A finances its subsidiary in State B, which then in return pays remuneration to its parent company in State A, both jurisdictions involved have to qualify the form of finance either as debt or equity. The qualification depends however predominantly on domestic legislation of the States concerned. A Hybrid mismatch is likely to occur as soon as State B treats the remuneration paid by the subsidiary as interest, while from a perspective of State A, the payment qualifies as equity or vice versa. As a result State B will usually grant a deduction for the interest paid, while State A may exempt the payment as remuneration of equity. Hence, no tax is levied and double non-taxation emerges (negative qualification conflict).²⁰ Yet, there is not only a risk of double non-taxation, but also of double taxation (positive qualification conflict).²¹ Double taxation may occur right at the moment when State B qualifies the remuneration payment as equity and taxes it accordingly, whereas State A treats the incoming remuneration as interest income and levies income tax accordingly.²²

Treatment of perpetual debt may serve as an appropriate example of a hybrid financial instrument. Whereas perpetual debt is treated as debt in some jurisdictions, it will most likely be re-characterized as equity-like attributions of the perpetual investment in the US. The income of the perpetual debt will therefore qualify as dividend and hence entitle the owner to an indirect foreign tax credit.²³ Taxpayers are generally said to be very thriving in using perpetual debt to achieve inconsistent cross-border treatment.²⁴ In any case this is only one out of countless manifestations²⁵ of hybrid mismatch arrangements. Noteworthy, double non-taxation is also likely to occur as a result of an intended tax incentive granted by one of the states concerned.

¹⁸ S. E. Bärsch, *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context*, 2012, p. 41.

¹⁹ E. Eberhartinger, *Taxation of Cross-Border Hybrid Finance*, 2009, p. 4.

²⁰ E. Eberhartinger, M. Six, *Taxation of Cross-Border Hybr. Fin.: A Legal Analysis*, 2009, p. 4.

²¹ See also: K. D. Weber, *Tax Treaty Treatment of Dividend Related Payments under Share Loan Agreements*, 2014, p. 112.

²² *Ibid.*, p. 112.

²³ A. Krahnal, *International Hybrid Instr./Jurisdiction Depend. Characterization*, 2005, Ch. III.

²⁴ *ibid.*, Ch. III.

²⁵ OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 30 f.

In order to curb those arrangements, the report calls for both adjustments of domestic legislation and the MC as well. The proposed changes to domestic legislation shall also ensure that a payment may not be deducted twice.²⁶

That being said, the OECD targets two types of arrangements, namely double deduction and Deduction/No-Inclusion situations. The latter relates to arrangements where a payment is deductible in the payer jurisdiction, but the same payment is not included in the payee's jurisdiction.²⁷ The former relates to arrangements, which give rise to a double deduction of one and the same payment.²⁸

As outlined previously, some arrangements bring about the risk of double taxation. On that note, Action 2 calls for enhanced co-ordination and the implementation of a tiebreaker rule, when more than one country seeks to apply the recommended rules.²⁹

But what is precisely suggested to allay those issues of double non-taxation?

2.1 Linking Rules

The OECD recommendations are based on linking rules to counter the negative effects of mismatch arrangements. Linking rules seek to align the tax treatment of a hybrid instrument in one jurisdiction with the counterparty's jurisdiction to achieve uniform treatment in both countries concerned.³⁰ These provisions are *inter alia* designed to prevent the application of dividend exemption rules in cases of deductible payments made under a financial instrument.³¹ Therefore, as regards D/NI outcomes, linking rules apply predominantly in situations, where the resident state does generally not include a certain income in its taxable base, although this item of income was already subject to a deduction in the source state.

In contrast to thin-cap rules, linking rules do not re-characterize the hybrid instrument from debt to equity or vice versa. They do only allocate the right to tax.³²

2.1.1 Primary Rule

When it comes to arrangements that amount to Deduction/No-Inclusion outcomes, the Report advocates a primary rule according to which the payer's ju-

²⁶ OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 14.

²⁷ *Ibid.*, p. 14.

²⁸ *Ibid.*

²⁹ *Ibid.*, p. 14 subs.

³⁰ OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 12.

³¹ OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 13.

³² R. de Boer, BEPS2, *Neutralizing the Effects on Hybrid Mismatch Arrangements*, 2015, p. 24.

jurisdiction has to deny the deduction of outbound payments, in cases where those payments were not included in the payee's taxable income.³³ Hence, the provision requires the payer's jurisdiction to possess certain knowledge of the foreign tax treatment. The recommended rule under paragraph (a) of the title "Neutralise the mismatch to the extent payment gives rise to a D/Ni Outcome", reads as follows:

"The payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/Ni outcome."³⁴

As a critical point, the scope of this rule shall be limited to financial instruments held by related parties.³⁵ The Report requires therefore a standard of 25 % direct or indirect ownership to qualify as a related party.³⁶

Yet, in case of a "structured arrangement", the scope will automatically be extended to non-related parties, either.³⁷

2.1.2 Secondary Rule

However, if the payer's jurisdiction does not enforce the primary rule, the risk of double non-taxation is still present. Consequently, the deliverable endorses a secondary, "defensive rule", which allows the payment to be included as ordinary income in the payee's jurisdiction.³⁸ This rule is particularly tailored for countries that apply domestic dividend exemption schemes.

The defensive rule reads as follows:

"If the payer jurisdiction does not neutralise the mismatch then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/Ni outcome."³⁹

Therefore the Report recommends that those jurisdictions, which apply dividend exemption schemes, shall not extend this exemption to situations where the dividend is already deductible in the Source State.⁴⁰

³³ OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 15.

³⁴ Ibid p. 37.

³⁵ OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 36.

³⁶ R. de Boer, BEPS2, Neutralizing the Effects on Hybrid Mismatch Arrangements, 2015, p. 19: Conflict with PSD, see ch. 4.2.1.

³⁷ See Ch. 4.3: OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 36.

³⁸ Ibid., p. 15.

³⁹ OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 37.

⁴⁰ OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 40.

After all, it is reasonable to argue that the primary rule by itself may only achieve its aim of taxation of an item of income when it is transnationally applied. Transnational application of the primary rule would safeguard taxation of a hybrid instrument in the source state. Yet, uniform application may require a number of years.⁴¹ A situation where the primary rule is not applied by the source state will in all likelihood lead to double non-taxation. Therefore, If the primary rule is not applied, the secondary rule, as a defensive rule, makes sure that the hybrid instrument will at least be taxed once, in the resident state.

As a result, while the primary rule is not in all circumstances sufficient to achieve taxation of a hybrid instrument, the secondary rule works as a backup provision and ensures taxation thereof. Hence, application of both the primary and secondary rule ensures taxation of hybrid instruments following the subject to tax principle and mitigates double non-taxation.⁴²

However, the secondary rule allocates the taxing right to the resident state, which may yet be in conflict with general principles of source and resident taxation in some circumstances⁴³, given the fact that this item of income will usually have no economic link whatsoever to the resident state.

In return to what was already mentioned earlier, prosperity of these recommendations depends on a large scale on comprehensive ratification, which might be questionable from today's perspective.⁴⁴

Another problem particularly in respect of linking rules is that they require states to acknowledge the foreign law and also to be familiar with the tax treatment of an item of income in the counterparty's jurisdiction. While in first place that is not only an administrative burden, it may also become an unsolvable issue in a scenario where the resident country itself is uncertain about the accurate treatment within its jurisdiction.⁴⁵

Yet, it remains sketchy, if for instance a 95 % participation exemption granted in the payee's state will be deemed as not included and hence trigger application of the primary rule in the source state. And vice versa, if 5 % taxation in the source state may be considered as included in the foreign tax base?⁴⁶ Further guidance is urgently required.

⁴¹ R. de Boer, BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements, 2015, p. 20; M. Gilleard, In search of harmony: Finding a consensus on hybrid mismatches, 2014.

⁴² See ch.: 2.2.1.

⁴³ See ch. 2.2 below: J. Lüdicke, "Tax Arbitrage" with Hybrid Entities: Challenges and Responses, 2014, p. 316.

⁴⁴ M. Gilleard, In search of harmony: Finding a consensus on hybrid mismatches. in: International Tax Review, 2014, Vol. 25, Issue 5.

⁴⁵ M. Gilleard, In search of harmony: Finding a consensus on hybrid mismatches. in: International Tax Review, 2014, Vol. 25, Issue 5.

⁴⁶ T. J. Wielenga, TEI Comments on BEPS Action 2: Hybrid Mismatch Arrangements, 2014.

2.2 Underlying Principles of Source and Resident Taxation

Since linking rules are designed to allocate the taxing rights among jurisdictions, it is at first place decisive to create a common understanding of the basic principles of source and resident taxation.

From an international perspective, it is generally accepted, that countries tax their residents based on their worldwide income, while non-residents are only taxed on income arising within their borders.⁴⁷ Source based taxation follows the principal of territoriality⁴⁸, which implies for instance, that a state should not have tax competence over non-resident subsidiaries.⁴⁹

Due to the fact that this system will likely lead to a situation where an item of income being subject to tax in both the resident and the source state, jurisdictions negotiate tax treaties to provide relief of double taxation. It is therefore well established that the source countries' taxing rights prevail over the income that arises within its borders. Consequently, it is for the resident state to provide relief from double taxation.⁵⁰

Relief is either achieved by the exemption method, or by adopting a tax-credit for the taxes paid in the source state. These principles may yet be limited by certain applicable General-Anti Avoidance Rules (GAARs), for instance CFC or Thin-Cap rules.

Another generally accepted principle is that active business income should be taxed at source, while passive income will be taxed on a residence basis.⁵¹

However, if the resident country applies a participation exemption scheme and a certain income is not taxed in the source state, this will lead to double non-taxation. A switchover to a foreign tax-credit may yet provide decent remedy thereof.⁵²

Deduced therefrom, states enforce their jurisdiction from the nationality and the territoriality principle.

It appears, as regards passive income, that the primary linking rule breaks the principle according to which it is for the resident state to tax that income, because it transfers the right to tax to the source state. The same is true for the defensive rule in a situation where active income is not taxed in the source state, but following the secondary rule, included into the taxable income of the resident state. Hence, linking rules bear the risk to run contrary to the "no taxa-

⁴⁷ R. S. Avi-Yonah, *Advanced Introduction to International Tax Law*, 2015, p. 3.

⁴⁸ O. Marres, *The Principle of Territoriality and Cross-Border Loss Compensation*, 2011, p. 113; C-446/03 *Marks & Spencer*, par. 39.

⁴⁹ O. Marres, *The Principle of Territoriality & Cross-Border Loss Compensation*, 2011, p. 114.

⁵⁰ R. S. Avi-Yonah, *Advanced Introduction to International Tax Law*, 2015, p. 4.

⁵¹ R. S. Avi-Yonah, *Advanced Introduction to International Tax Law*, 2015, p. 4.

⁵² R. S. Avi-Yonah, *Advanced Introduction to International Tax Law*, 2015, p. 43.

tion without representation”-principle. The German constitutional Court did already challenge the bond-buying program of the European Central Bank based on this principle.⁵³

However, according to a literal interpretation method, both the primary and the secondary rule apply only “to the extent it gives rise to a D/NI outcome”, which might therefore be viewed as *lex specialis*, as well, since they only apply in deduction and non-inclusion situations.

2.2.1 Single Tax Principle and Neutrality

Linking rules do therefore ascertain that a hybrid instrument will be subject to tax at least once, thus taking into account the single tax principle⁵⁴, which ensures avoidance of double non-taxation. Hence, the primary and the secondary rule may from a technical perspective ensure single taxation of a hybrid instrument, although they entail a number of shortcomings.

Some concerns are related to the concepts of Capital Import Neutrality (CIN) and Capital Export Neutrality (CEN). In this respect, the secondary rule, which allows to refrain from the exemption method and to tax certain income instead, may be contrary to the envisaged CIN, since inbound investments would be rendered unattractive. The same is true for the primary rule being contradictory to CEN, as outbound investments are less attractive.

Since mismatches occur predominantly in the context of passive income, the primary rule facilitates access to an item of income to which a jurisdiction has no link whatsoever and is thus contrary to the principles of source and resident taxation.

In the authors view, the alleged linking rules pursue the aim to tax an item of income at least once, but they may also be found to be contrary to these general allocation principles. AG Kokott argues, that the single tax-principle is also inherent in the justification based on the coherence of the tax system, which will be discussed further below.⁵⁵

3 Linking Rule in Germany

Raffaella Russo, director of the BEPS project, said that some countries move ahead with implementing measures, is “evidence of the fact that there is political pressure to fix problems and to do it quickly.”⁵⁶

⁵³ P. de Grauwe, Why the European Court of Justice should reject the German Constitutional Court’s ruling on Outright Monetary Transactions, 2014.

⁵⁴ R. S. Avi-Yonah, Advanced Introduction to International Tax Law, 2015, p. 5.

⁵⁵ C-319/02 Manninen [2004], AG Kokott Opinion, par. 51.

⁵⁶ A. Athanasiou, Jumping the Gate on BEPS Unilateral Actions, 2015, p. 937.

On that note, Germany anticipated the measures of the OECD and did already implement a linking rule in its domestic corporate income tax scheme (CIT) by way of extending the scope of its matching principle (“Materielles Korrespondenzprinzip”).⁵⁷

On general terms, German incorporated taxpayers are subject to both corporate income and trade tax.⁵⁸ Interest payments are fully deductible at a corporation level, while dividend payments are not tax deductible at a corporation level.⁵⁹ However, the German CIT grants a participation exemption scheme to corporate dividend recipients, holding at least 10 % of share capital in the distributing company.

As a result, dividends are generally exempt at the shareholder level in order to avoid economic double taxation, despite of 5 %, which is considered a non-tax-deductible business expense.

However, tax authorities may now refuse to grant the participation exemption based on the new linking rule. The new provision reads as follows:

“The participation exemption scheme does only apply to the extent, that the earnings did not reduce the income of the distributing entity.”⁶⁰

This rule limits the scope of the participation exemption (“Schachtelprivileg”) for dividends in case of hybrid financial instruments.⁶¹ Thus, any income received by a German company, which would typically fall under the participation exemption scheme, will no longer be exempt if the payment was already deductible at the level of the distributing company.⁶² As a corollary, such payment, which led to a deduction at the level of the payer, will be subject to German corporate taxation and solidarity surcharge, too.⁶³

3.1 Compliance with Domestic Law

Procedural issues arise in relation to the new provision. In order to determine if the payment led to an income reduction of the foreign company, the foreign tax legislation is decisive⁶⁴, which may cause an additional administrative burden on both the German and the foreign-based company. On the same token it is not clear, who will be liable to furnish the relevant evidence. According to § 88 of

⁵⁷ C. Kahlenberg, *Prevention of Double Non-taxation: An Analysis of Cross-Border Financing from a German Perspective*, 2015, p. 225.

⁵⁸ S.-E. Bärsch: *Hybrid Mismatch Arrangements: OECD Recommendations and German Practice*, 2013, p. 525.

⁵⁹ *Ibid.*

⁶⁰ Free translation of § 8b I 2 KStG.

⁶¹ A. Schnitger, M. Weiss, *Empfehlungen der OECD zu „Hybrid Mismatches“ für die nationale – Steuergesetzgebung*, 2014, Ch. 3.

⁶² *Ibid.*

⁶³ O. Wehnert, *German Tax Planning: Anti Hybrid Financing Measures*, 2015.

⁶⁴ L. Richter, D. Reeb, Z. *Ausdehnung d. materiellen Korrespondenzprinzips in § 8b Abs. 1 S. 2 KStG durch d. AmtshilfeRLUMsG i. Spannungsfeld von Europa- und VölkerR*, 2015, S. 42.

the General Fiscal Law, it is for the tax authorities to determine the relevant facts. Yet, as regards cross-border situations, § 90 par. 2 AO states, that the taxpayer has a duty to collaborate and also bears the burden of proof for tax concessions.

Irrespective of any EU law implications, this outcome is contrary to the pursued aim by the German legislator to “facilitate and modernize the CIT”⁶⁵. In addition it remains highly questionable if a taxpayer can even furnish evidence of a non-performed income-reduction at the level of the distributing company.⁶⁶ This may likely prove to be impossible in certain situations, since there is generally no data available on “non”-performed deductions.

Furthermore, the regulation will have as a consequence that Germany will tax income, which in itself does not belong to its tax base. Moreover, incentives granted by other states to attract foreign investments are revoked by the German legislation, which is also contrary to the concept of CIN.⁶⁷ However, this assumption does only hold true unless the source state applies the primary rule following the OECD proposals. In this scenario, the primary rule would allow the source state to tax the instrument and CIN would ultimately be maintained.

Yet, a scenario, in which both rules were applied simultaneously by each of the jurisdictions, entails also a risk of double taxation. To prevent this outcome, the OECD seeks to design a tiebreaker rule in future deliverables.⁶⁸

It is also disputable, whether this rule will bring any benefit compared to already existing provisions. Firstly, there are already comparable provisions in the German Tax Code, which would allow the tax authorities to refuse exemption of certain income, even if provided by a tax treaty.⁶⁹ Secondly, the supreme fiscal Court accepted denial of exemption for certain hybrid payments, too.⁷⁰ Some authors argue that the GAARs of §§ 41, 42 of the fiscal code will be capable to achieve the same result.⁷¹ The author is however of the opinion, that GAARs are not efficient to counter hybrid mismatches, which will be discussed further below.⁷²

According to the German Bundesrat, the main purpose of this legislation is to counter arrangements, which are liable to generate “white earnings” (e.g. dou-

⁶⁵ Bundesrat, Drucksache 54/11, 2011.

⁶⁶ Becker, Loose: Zur geplanten Ausdehnung des materiellen Korrespondenzprinzips auf hybride Finanzierungen, 2012, p. 760.

⁶⁷ Becker, Loose: Zur geplanten Ausdehnung des materiellen Korrespondenzprinzips auf hybride Finanzierungen, 2012, p. 761.

⁶⁸ OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 25.

⁶⁹ § 50d par. 9 KStG.

⁷⁰ BFH v. 4. 6. 2008, I R 62/06, BStBl II 2008, 793, IStR 2008, 739.

⁷¹ Becker, Loose: Zur geplanten Ausdehnung des materiellen Korrespondenzprinzips auf hybride Finanzierungen, 2012, p. 762.

⁷² See ch. 4.3 below.

ble non-taxation) due to negative cross-border conflicts of qualification standards.⁷³ However, that purpose finds only poor reflection in the wording of the legislation.⁷⁴ In fact, the rule applies not only to hybrid instruments, but to all sorts of profit distributions.⁷⁵

Additionally, the scope of the provision is limited to earnings that must have reduced the income of the paying company. Hence, it does not cover earnings, which were not subject to tax on the level of the paying company and did therefore not reduce the income of the latter.⁷⁶ The legislation is to that extent not fully effective to cover all kinds of hybrid mismatches and double non-taxation is not entirely abolished.

It follows, the wording of the German linking rule is broader than its intended aim and it does also not mitigate double non-taxation in every situation.

Incidentally, hybrid mismatches, which generate double taxation, do not fall in the scope of the law, which is a cause for criticism among German jurisprudence.⁷⁷

3.2 Compliance with the OECD Recommendations

The German rule applies in particular to inbound dividends, and enables the resident state (Germany) to tax incoming payments to the extent that those have not been subject to tax in the source state. Upon first sight, this provision seems to be tantamount to the secondary rule of the OECD recommendations⁷⁸, since both align the treatment of an item of income in the resident state with the respective treatment in the source state.

However, following a literal interpretation of the German legislation, it covers not only hybrid instruments but also other profit distributions, such as ordinary dividends unless those were subject to tax in the source state.

As regards their scope, the German legislation of § 8 b I KStG requires a 10 % shareholding to apply, as opposed to the 25 % threshold proclaimed by the

⁷³ L. Richter, D. Reeb, Zur Ausdehnung d. materiellen Korrespondenzprinzips in § 8b Abs. 1 S. 2 KStG durch d. AmtshilfeRLUmsG i. Spannungsfeld von Europa- und VölkerR, 2015, p. 41.

⁷⁴ Ibid, p. 53.: Bundesrat, Drucksache 205/14, 2014.

⁷⁵ C. Kahlenberg, Prevention of Double Non-taxation: An Analysis of Cross-Border Financing from a German Perspective, 2015, p. 225.

⁷⁶ L. Richter, D. Reeb, Zur Ausdehnung d. materiellen Korrespondenzprinzips in § 8b Abs. 1 S. 2 KStG durch d. AmtshilfeRLUmsG i. Spannungsfeld von Europa- und VölkerR, 2015, p. 42.

⁷⁷ Ibid.

⁷⁸ C. Kahlenberg, Prevention of Double Non-taxation: An Analysis of Cross-Border Financing from a German Perspective, 2015, p. 218; W. Staats, Zur Neutralisierung Hybrider Gestaltungen - Der OECD-Bericht zu Maßnahme 2 des BEPS-Aktionsplans, 2014, Ch. 3.

OECD recommendations. As a result, the scope of the German legislation is clearly broader than proposed by the OECD.⁷⁹

Notwithstanding, since those rules deny a deduction in the source state, which would otherwise be granted, concerns may arise in relation to the non-discrimination article of the OECD Model Convention.

While the German linking rule does not require a cross-border payment in order to apply, it does actually only apply in cross-border situations, since a qualification conflict may in all likelihood not be found to exist in a plain domestic scenario.⁸⁰ Therefore, one may envisage a covert discrimination in the sense of Article 24 MC. However, as stated in the Commentary, Article 24 may only apply in cases of overt discriminations.⁸¹

In contrast to that, the supreme German Fiscal Court (BFH) rendered that also covert discriminations shall be in the scope of Article 24 MC. It remains to be seen if the German Fiscal Court will maintain its jurisprudence against the backdrop of the BEPS recommendations.⁸²

The OECD is however also working on several treaty amendments, which may resolve the issue in the near future.

It follows, albeit both the national German linking rule and the defensive rule pursue identical aims, there remain differences as regards their design and scope.

3.2.1 Treaty Override

Incidentally, the German legislation may in some instances result in a treaty-override.

According to settled case law of the supreme fiscal court, both German domestic legislation and Treaty law are of equal value.⁸³ In a conflict between a treaty rule and a domestic rule, preference must be given to the less restrictive rule. In respect of passive income, Article 10 of the MC is less restrictive, since its application is only tied to the condition of a 10 % shareholding in a related company. This may very likely lead to an outcome, where Germany is forced to exempt a hybrid instrument, contrary to the national linking rule, but as a corollary of the applicable Tax treaty.⁸⁴ However, this outcome has been anticipated

⁷⁹ C. Kahlenberg, *Prevention of Double Non-taxation: An Analysis of Cross-Border Financing from a German Perspective*, p. 225, 2015; M. Desens, *Kritische Bestandsaufnahme zu den geplanten Änderungen in § 8b KStG, 2014*, Ch. 2.1.

⁸⁰ A. Schnitger, M. Oskamp, *Empfehlungen der OECD zur Neutralisierung von "Hybrid Mismatches" auf Abkommensebene, 2014*, Ch. 3.5.

⁸¹ *Ibid.*

⁸² *Ibid.*

⁸³ Compare: BFH v. 14.1.2009 - IR47/08, BStBl II 2011, 131, IStR 2009, 424 Rz. 15.

⁸⁴ L. Richter, D. Reeb, *Zur Ausdehnung d. materiellen Korrespondenzprinzips in § 8b Abs. 1 S. 2 KStG durch d. AmtshilfeRLUMsG im Spannungsfeld v. Europa- und VölkerR, 2015*, p. 53.

by the German legislator, who did therefore implement another sub-clause in § 8 b I KStG. § 8 b I clause 3, states that the denial of a participation exemption according to the domestic linking rule does still apply even if a treaty would provide for the contrary.⁸⁵ Evidently, this regulation amounts to a treaty-override. The German Federal Tax Court did already hold a treaty-override to be unconstitutional.⁸⁶ This matter is now referred to the Supreme Constitutional Court. If this case leads to invalidity of the treaty-override, the linking rule would remain without any effect.

It may however be said that in particular newly negotiated tax treaties do include subject-to-tax clauses, which are akin to the German domestic linking rules.⁸⁷ According to Lang, changes to tax treaties bear however the risk of a reverse interpretation, according to which precisely those new principles were not binding in other treaties.⁸⁸

3.3 Compliance with EU Law

Significant focus has to be drawn to the new rule in respect of possible impacts that EU law might have on it. Especially the non-discrimination concept, inherent in the Treaty on the Functioning of the European Union (TFEU), has been used by the ECJ to strike down several tax provisions of its Member States.⁸⁹

One may bear in mind that direct taxation within the EU is in principal a matter of each Member State's juridical sovereignty, as opposed to indirect taxation, which is harmonized and in so far exclusively subject to supranational legislation. However, one would be mistaken to assume that Member States of the EU are entirely free to enact direct tax legislation ad libitum and would therefore not be subject to the constraints of primary and secondary EU law.⁹⁰ On the contrary, all national legislation must comply with primary EU law, namely the TFEU, and above all the Fundamental Freedoms thereof.⁹¹ The Treaty is aimed to create a Common Market with an economic monetary union and a common currency.⁹² Any unjustified restriction or discrimination imposed by national legislation bears the risk to infringe primary EU law and might be declared void by the ECJ.

⁸⁵ § 8 b I S. 3 KStG.

⁸⁶ BFH I R 4/13: A. Cloer, T. Hagemann, F. Tax Court Holds Treaty Override Unconstitutional, 2014, p. 510.

⁸⁷ L. Richter, D. Reeb, *supra*. 84, p. 53.

⁸⁸ M. Lang, BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties, 2014, p. 656; See also Ch. 4.3.

⁸⁹ R. S. Avi-Yonah, *Advanced Introduction to International Tax Law*, 2015, p. 66.

⁹⁰ E. Traversa, Interest Deductibility and the BEPS Action Plan: nihil novi sub sole? 2013, p. 7.

⁹¹ J. Bundgaard, Hybrid Financial Instruments and Primary EU Law – Part 1, 2013, p. 539.

⁹² C. Brokelind and others, *Business Taxation Within and Across the Borders of the European Union*, 2003, p. 38.

Due to the fact, that the domestic German legislation is akin to the defensive rule suggested by the OECD, the following elaboration will focus on whether that rule complies with EU law.

According to settled case law of the ECJ, the Court will as a first step investigate which of the fundamental freedoms may fall in the scope of the relevant provision. Subsequently, the Court will determine if the provision at hand causes a restriction to the relevant freedom. Finally, if there are no grounds of justification, the measure at issue will likely be found to violate EU law.

3.3.1 Determination of the Applicable Freedom

In the first place, it needs to be established, which of the freedoms will eventually apply to the German linking rule.

Linking rules will most likely be assessed in light of the freedom of establishment⁹³ and the free movement of capital⁹⁴. According to well-established case law of the ECJ, application of the freedom of establishment depends as a general rule on the existence of a certain shareholding in another company in a cross-border situation. Therefore the ECJ applies the freedom of establishment in cases, where a definite influence in another company is to be found. In FII Group-Litigation, the ECJ held, that a 10 % shareholding might not be sufficient to qualify as a definite influence.⁹⁵ However, also minority shareholdings may in some instances lead to a definite influence.⁹⁶ Where no definite influence is to be found, the free movement of capital will arguably be applied.⁹⁷ The latter also covers arrangements tied to third countries.

Since the German linking rule requires a shareholding of at least 10 %, it will most likely depend on a case-by-case study if the Court applies the freedom of establishment or the free movement of capital.

3.3.2 Restriction of the Relevant Freedom

In order to cause a restriction to the relevant freedom, the national legislation must cause an unjustified discrimination to the applicable freedom.

⁹³ Article 56 TFEU; J. Bundgaard, Hybrid Financial Instruments and Primary EU Law – Part 1, 2013, p. 540.

⁹⁴ Article 63 TFEU; L. Richter, D. Reeb, Zur Ausdehnung des materiellen Korrespondenzprinzips in § 8b Abs. 1 S. 2 KStG durch 49 das AmtshilfeRLUMsG im Spannungsfeld von Europa- und Völkerrecht, 2015, p. 49.

⁹⁵ C-446/04 Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue [2006], par. 36 f.

⁹⁶ C-326/07 Commission vs. Italy [2009], par. 38; also Kokott, AG opinion in C-311/08 Société de Gestion Industrielle SA (SGI) v État belge [2010], par. 35.

⁹⁷ M. Helminen, EU Tax Law – Direct Taxation, 2013, p. 123 ff; M. Desens, Kritische Bestandsaufnahme zu den geplanten Änderungen in § 8b KStG, 2014, Ch. 2.2.1.

A restriction is present, when different rules are applied to comparable situations or the same rules are applied to different situations.⁹⁸ In order to find a comparable situation, the Court relies either on a vertical or on a horizontal approach.⁹⁹ While the vertical approach compares a domestic and a cross-border situation, the horizontal approach compares two cross-border situations.¹⁰⁰

Approval of a restriction depends also on if the Court compares the Group as a whole or on a standalone basis, which is tantamount to either, a per-country or an overall approach.¹⁰¹ As regards the situation of resident countries, the Court appears to give precedence to the overall approach, which means that the Court takes the situation in another country into consideration in order to determine if a certain provision infringes EU law.¹⁰²

As the German rule does not explicitly distinguish between domestic and cross-border situations, it may only constitute a covert discrimination¹⁰³ based on nationality. Yet, according to the ECJ, even covert discriminations may infringe EU law, unless justified.¹⁰⁴

A rule that denies a domestic participation exemption in certain cross-border situations, which instead includes the income in the national tax base, is equivalent to the German rule and may by virtue of this implication constitute a restriction to the freedom of establishment, since cross-border situations are treated less favourably compared to pure domestic set-ups.¹⁰⁵ Likewise, Prof. Desens argues, the German legislation is very likely to cause a discrimination to EU law.¹⁰⁶

On the other hand, the Court did not find a restriction in the Columbus Container verdict, where a domestic rule provided for a switch over from an exemption method to a tax credit if an entity was subject to low taxation abroad.¹⁰⁷ This was also confirmed by the Court's Grand Chamber in the Kerckhaert-Morres case.¹⁰⁸ Additionally, the Court accepted juridical double taxation as a result of the exercise of each Member States fiscal sovereignty, "which may only be

⁹⁸ C- 279/93 Finanzamt Köln-Altstadt v Roland Schumacker [1995], par. 30.

⁹⁹ J. Bundgaard, Hybrid Financial Instruments and Primary EU Law – Part 1 2013, p. 550.

¹⁰⁰ Ibid.

¹⁰¹ J. Bundgaard, Hybrid Financial Instruments and Primary EU Law – Part 1 2013, p. 550.

¹⁰² M. Lang, ECJ case law on cross-border dividend tax. ± recent developments, 2008, p. 72.

¹⁰³ Ibid.

¹⁰⁴ M. Helminen, EU Tax Law, 2013, Ch. 2.1.2.

¹⁰⁵ J. Bundgaard, Hybrid Financial Instruments and Primary EU Law – Part 1, 2013, p. 550; P. Wittenstein, Momentaufnahme zur Steuergestaltung mit hybriden Finanzinstrumenten: "Luxembourg Leaks" und neue Gesetze(-svorhaben) in Europa, 2015, Ch 4.3.3.

¹⁰⁶ M. Desens, Kritische Bestandsaufnahme zu den geplanten Änderungen in § 8b KStG, 2014, Ch. 2 & 2.2.1.

¹⁰⁷ C-298/05 Columbus Container Services BVBA & Co v Finanzamt Bielefeld-Innenstadt [2007], par. 38.

¹⁰⁸ C-513/04, Kerckhaert-Morres v Belgische Staat [2006], par. 17.

solved by harmonizing the tax systems” between Member States.¹⁰⁹ It also clarified that the situation of resident dividend recipients and non-resident dividend recipients is not necessarily comparable.¹¹⁰ The Court rendered in its Schempp decision that rules, which address inconsistencies among different tax systems, do not infringe the fundamental freedoms, because of a lack of comparability.¹¹¹ In this case, the ECJ allowed Germany to apply a deduction for maintenance payments based on the condition that those are taxed in another Member State. According to the Court, this treatment causes a disparity rather than discrimination.¹¹² Thus, autonomous qualification of hybrid instruments is a mere consequence of the simultaneous application of domestic rules.¹¹³ While that case law serves as an argument, that the German linking rule might conceivably not cause a restriction, other case law provides for the contrary assumption. On that note, the Court held in *Eurowings*, that any advantage which is granted in a low tax country, cannot itself authorize another Member State to neutralize that advantage by imposing an additional tax in that state.¹¹⁴

It follows, that there is clearly a clash of different assumptions. While most of the scholars argue that this provision may likely cause a restriction, the previous case law is rather inconsistent. In the author’s view, finding of a restriction depends eventually on a case-by-case assessment. It is therefore necessary to analyse if a possible restriction may be justified, though.

3.3.3 Justification of the Relevant Freedom

Unless the provision is not justified due to overriding reasons of public interest¹¹⁵, the German legislation may likely be found to jeopardize the EU fundamental freedoms. Possible justification grounds may be seen in the need to prevent tax avoidance and the necessity to maintain the coherence of the tax system.

This chapter will only briefly cover the relevant justifications. A more in-depth analysis follows in context of the primary rule below.¹¹⁶

A justification based on the need to prevent tax avoidance may yet be ill founded, because the German legislation does not precisely refer to artificial ar-

¹⁰⁹ C-513/04, *Kerckhaert-Morres v Belgische Staat* [2006], par. 22.

¹¹⁰ C-170/05 *Denkavit Internationaal BV v Ministre de l’Économie, des Finances et de l’Industrie* [2006], par. 34.

¹¹¹ C-403/03 *Egon Schempp v Finanzamt München V* [2005], par. 34: C. Marchgraber, *Tackling Deduction and Non-Inclusion Schemes – The Proposal of the European Commission*, 2014, p. 139.

¹¹² D. Weber, *Tax coordination: a joint responsibility of the Member States. Still a fantasy?* 2007, p. 162.

¹¹³ J. Bundgaard, *Hybrid Financial Instruments and Primary EU Law – Part 1*, 2013, p. 541.

¹¹⁴ C-294/97 *Eurowings Luftverkehr AG v Finanzamt Dortmund-Unna* [1999], par. 44.

¹¹⁵ C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* [2007], par. 64.

¹¹⁶ See ch. 4.1.2.

rangements, which is required by the ECJ in several judgments.¹¹⁷ There is no particular reference to wholly artificial arrangement in the German law.¹¹⁸

Noteworthy, the Court also held, that a loss in tax revenue cannot be regarded as an overriding reason in public interest to justify a restrictive provision.¹¹⁹

A further possible justification may be seen in the necessity to maintain the coherence of the tax system, since the German Rule prevents application of a certain tax benefit (participation exemption) only to the extent that the related payment was already subject to tax beyond its borders. There is also a direct link between the denial of the tax benefit and the incomes resulting thereof.¹²⁰

However, this rule allows Germany access to income, to which it has no economic connection and is thus in conflict with the principle of no taxation without representation. On the other hand, the Court seems recently reluctant to accept justifications based on territoriality.¹²¹

Incidentally, even if the German legislation would be justified based on the coherence of the tax system, it must nevertheless be proportionate to achieve its intended aim, too. A national rule must not go beyond what is necessary to achieve its intended aim.

Albeit the legislation is aimed to counter “white earnings”, it is only capable to oppose double non-taxation of income, which has actually been identified for tax purposes in the other state. Unidentified income may still lead to double non-taxation. Consequently, the provision is not in every respect adequate to pursue its aim. Secondly, it may be considered to be not appropriate, as its scope is not only limited to hybrid instruments but to any type of income. Moreover, excessive compliance burdens may also render the legislation inappropriate.

As a consequence, the ECJ would arguably reject such legislation based on a lack of appropriateness.¹²²

Prima facie, the German linking rule runs the risk to be contradictory to the EU fundamental freedoms.¹²³ It remains yet to be seen if the legislator will amend the legislation in order to comply with the new linking rule, which has been implemented in the PSD.¹²⁴

¹¹⁷ C-196/04 Cadbury Schweppes plc v Commissioners of Inland Revenue [2006], par. 51:

C-318/10, Société d’investissement pour l’agriculture tropicale (SIAT) v État belge, par. 40.

¹¹⁸ M. Desens, Krit. Bestandsaufnahme zu den gepl. Änderungen in § 8b KStG, 2014, p. 21.

¹¹⁹ C-319/02 Manninen [2004], par. 49.

¹²⁰ C-319/02 Manninen [2004], par. 49.

¹²¹ See ch. 4.1.2.1.

¹²² L. Richter, D. Reeb, Z. Ausdehnung d. materiellen Korrespondenzprinzips in § 8b Abs. 1 S.

2 KStG durch d. AmtshilfeRLUMsG i. Spannungsfeld von Europa- und VölkerR, 2015, p. 51.

¹²³ Ibid, p. 51.

¹²⁴ See ch. 4.2 below.

4 Linking Rules at the Benchmark of EU Law

While the analysis before did already address possible impacts of EU Law on the defensive rule, two further issues have to be taken into consideration. In the first place, it is also decisive to examine if the proposed primary linking rule complies with EU law. To recall, once a EU Member State implements a domestic law based on the OECD recommendations, it will unfold legal effect and is bound to comply with supranational law.

The second issue, which will be dealt with hereafter, is devoted to the enacted linking rule in the Parent-Subsidiary Directive. In contrast to the OECD recommendations, a Directive is legally binding to the Member States as to the result to be achieved.¹²⁵

4.1 Compliance of the Primary Rule with EU Law

The primary rule as recommended by the OECD, requires the payer-jurisdiction to tax an instrument, which is under normal circumstances exempt, dependent on the condition that the payee's jurisdiction does not include the respective income in its tax base. This legislation is therefore predominantly related to outbound situations. Incidentally, the primary rule will be assessed based on the freedom of establishment and the free movement of capital.

4.1.1 Restriction of the Relevant Freedom

Again, to be compatible with primary EU law, the legislation at issue must not cause a restriction to the fundamental freedoms.

Under the vertical approach, the primary rule may very likely cause discrimination, since only cross-border set-ups run the risk to be taxed whereas in a pure domestic situation, exemption schemes apply. In the SGI case, the Court applied a vertical approach and stated that a provision may be liable to cause a restriction to the fundamental freedoms if it treats a domestic situation differently than a cross-border arrangement.¹²⁶

On the other hand, the horizontal approach may only lead to a restriction depending on the chosen comparison by the Court. For instance, if the Court compares the relevant situation with a situation in another jurisdiction where the same treatment applies, no discrimination will be found and vice versa.

In any event, comparability does always hinge on a case-by-case assessment, depending on the specific legal background of the relevant case, which is also confirmed by M. Lang.¹²⁷

¹²⁵ Article 288 TFEU.

¹²⁶ C-311/08 *Société de Gestion Industrielle SA (SGI) v État belge* [2010], par. 50.

¹²⁷ M. Lang, ECJ case law on cross-border dividend tax. ± recent developments, 2008, p. 74.

It turns out, although by admitting that it is rather difficult to draw a final conclusion, the primary rule entails at least certain risk to cause a restriction, since it treats outbound payments different than pure domestic set-ups. This does also depend on whether the Court would eventually assess the comparability based on a vertical or horizontal approach. Advocate General (AG) Kokott also suspects that a rule, which would only apply depending on certain tax treatment in another country, will arguably result in a restriction of the fundamental freedoms.¹²⁸

4.1.2 Justification of the Restriction

As a next step, it must be examined if there are any possible justification grounds, which would be accepted by the ECJ.

4.1.2.1 Coherence of the Tax System

A possible justification may be seen in the need to ensure the coherence of the national tax system, which was already accepted by the ECJ in the *Bachman-Case*.¹²⁹ Cohesion of the tax system is “the grant of a tax advantage and the offsetting of that advantage by a fiscal levy.”¹³⁰ According to the Court, the need to preserve the cohesion of the tax system has to be examined on the basis of objectives pursued by the relevant tax system.¹³¹ Additionally, it requires a direct link between a tax advantage and the compensation of this advantage.¹³² It appears, though, that the Court does not accept a direct link in a situation where different taxpayers or different types of tax are concerned.¹³³ On that note, the ECJ already refused to find a direct link between a subsidiary and its parent company, because those are distinct legal persons, each being subject to tax liability on its own, so that a direct link cannot be relied upon.¹³⁴ Contrary to that, the ECJ accepted the cohesion justification in *Krankenheim*, where it found a direct link between a parent company and its permanent establishment.¹³⁵

In the authors view, it is rather arduous to find a consistent thread in the previous discussed case law, which exacerbates the problem if the Court would eventually rely on the justification based on the coherence of the tax system.

¹²⁸ S. Douma, *Legal Research in International and EU Tax Law*, 2014, p. 50: Compare: Joined Cases C-39/13 to C-41/13, AG Kokott opinion, par. 50 subs.

¹²⁹ C-204/90 *Hanns-Martin Bachmann v Belgian State* [1992], par. 35.

¹³⁰ C-35/98 *Staatssecretaris van Financiën v B.G.M. Verkooijen* [2000], par. 57.

¹³¹ C-9/02, *Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie* [2004], par. 67.

¹³² C-319/02 *Manninen*, par. 42.

¹³³ D. Weber, *An Analysis of the Past, Current and Future of the Coherence of the Tax System as Justification*, 2015, p. 51.

¹³⁴ C-168/01 *Bosal Holding* [2003], par. 32.

¹³⁵ C-157/07 *Finanzamt für Körperschaften i. Berlin v Krankenhaus GmbH* [2008], par. 53.

D. Weber argues that a general deduction restriction may only be justified if the beneficiaries of such treatment reside in another Member State.¹³⁶ In line with that reasoning, the Court held in *Amurta*, that a source state may levy taxes, in cases where a tax treaty provides for a tax credit in the resident state.¹³⁷

The cohesion justification relies on the assumption of fiscal territoriality and is also related to the justification based on the allocation of taxing rights.¹³⁸ As regards fiscal territoriality, the ECJ appears yet to take a shift off the territoriality principle. In the *Commission vs. Germany* verdict, the Court held, that a national rule, according to which a tax deferral on capital gains is subject to the condition, that those capital gains are reinvested within the territory of Germany, violates EU law. According to the Court, a reinvestment in another country would also enhance and promote the undertaking and could guarantee the continuity of economic activity.¹³⁹

AG Kokott argues the justification based on the coherence of the tax system can be regarded as a manifestation of the single-tax principle¹⁴⁰, which would also serve as an indication that the court would eventually accept coherence of the tax system as a valid justification with respect to linking rules in general.

Having settled that, the finding of a justification on grounds of the coherence of the tax system or the allocation of taxation powers, depends essentially on whether the ECJ maintains or abolishes its reasoning on the territoriality principle. From the author's perspective, the primary rule is arguably justified, if the ECJ discards the territorial nexus and takes account of the single tax principle. One must yet keep in mind, that a justification based on the allocation of taxing rights, may not serve as a standalone justification.¹⁴¹

4.1.2.2 Need to Prevent Tax Avoidance

Another justification may be seen in the need to prevent tax avoidance. In *Cadbury*, the Court explicitly required that restrictive measures might only be justified when the legislation at issue applies to wholly artificial arrangement, which do not reflect economic reality.¹⁴²

Tackling artificial arrangements is yet not a clear purpose of the primary rule at hand. Thus, prevention of tax avoidance may most likely not be found to justify

¹³⁶ D. Weber, *An Analysis of the Past, Current and Future of the Coherence of the Tax System as Justification*, 2015, p. 43.

¹³⁷ C-379/05 *Amurta SGPS v Inspecteur van de Belastingdienst/Amsterdam* [2007], par. 52; M. Helminen, *EU Tax Law – Direct Taxation*, 2013, p. 147.

¹³⁸ D. Weber, *An Analysis of the Past, Current and Future of the Coherence of the Tax System as Justification*, 2015, p. 53; M. Helminen, *EU Tax Law – Direct Taxation*, 2013, p. 146.

¹³⁹ C-591/13 *European Commission v Federal Republic of Germany* [2015], par. 77.

¹⁴⁰ C-319/02 *Manninen* [2004], AG Kokott Opinion, par 51.

¹⁴¹ J. Bundgaard, *Hybrid Financial Instruments and Primary EU Law – Part 2*, 2013, p. 589,;

See also : C-231/05 *Oy AA* [2007], C-414/06 *Lidl Belgium*.

¹⁴² C-196/04 *Cadbury Schweppes plc v Commissioners of Inland Revenue* [2006], par. 55.

the restriction of the relevant freedom. However, there seem to be some indications, that the Court is not as strict on this requirement anymore. In *Thin-Cap* the ECJ stated, that a rule, which targets only partly artificial arrangements might also be justified.¹⁴³ In any event, an artificial arrangement requires both subjective and objective elements.¹⁴⁴ Against this background it is crucial to remember that hybrid mismatches and double non-taxation are in some cases intended by states to attract foreign investment. Situations like these make it hard to prove any link to artificial arrangements. Moreover, the Court appears to be somewhat reluctant to find abusive behaviour by a taxpayer. It is settled case law that pursuing a tax advantage in another Member State cannot itself deprive a person of the right to rely on Community Law, and benefitting from such treatment does not in itself constitute abuse.¹⁴⁵ Based on these facts, it is rather unlikely, that the need to prevent tax avoidance will be an accepted justification by the ECJ.

Another justification may be seen in the prevention of double use of losses, which was object of justification in the well-known *Marks & Spencer* case. Admittedly, while the scope of this justification is narrow, the ECJ will likely not consider it as a justification ground in case of linking rules.¹⁴⁶

Conclusively, the primary rule operates on the very edge of compliance with EU law. Although, there are grounds to believe that the primary rule may be justified based on the coherence of the tax system, it is hard to argue that this outcome is absolutely certain.

As regards the proportionality test, the primary rule will arguably fail to be proportionate when it causes an excessive administrative burden to the taxpayer.

Apart from that, especially in the context of EU law, it is apparent that the BEPS recommendations do not take account of the constraints imposed by EU law, whatsoever.¹⁴⁷

4.2 Linking Rule in the Parent-Subsidiary Directive

The concerns raised in connection with base erosion are by no means exclusive sorrows of the OECD. In fact, the EU, whereof numerous of their Member States are integral part of the OECD, did also recognize the emerging debate. Therefore the issue arises, on how the EU deals with hybrid mismatches and what its impacts are (if any) on the OECD and vice versa. Whereas one may

¹⁴³ C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* [2007], par. 81.

¹⁴⁴ Although indirect taxation, C-255/02 *Halifax and others v Commissioners of Customs & Excise*, par. 54-55.

¹⁴⁵ C-255/02, *Halifax*, par. 73-75; A. P. Dourado, *Aggressive Tax Planning*, 2015, p. 44.

¹⁴⁶ See: C-231/05 *Oy AA* [2007], Par. 57.

¹⁴⁷ E. C. C. M. Kemmeren, *Where is EU Law in the OECD BEPS Discussion?* 2014, p. 190; S. Douma, *Leal Research in International and EU Tax Law*, 2015, p.49.

believe, that those are closely tied to one another, the subsequent elaboration will somewhat challenge this statement.

While the main purpose of the PSD is to avoid double taxation of cross-border profit distributions between parent companies and their subsidiaries¹⁴⁸, it has been exploited by several arrangements with the sole purpose to achieve double non-taxation, though.¹⁴⁹ Before the recent amendments were taken into place, Member States had to grant tax exemption to their resident parent companies in respect of dividends received from their EU subsidiaries in any event. Yet, to make it ready for operation against base erosion, the Commission amended its Parent-Subsidiary Directive, which does now entail an anti-hybrid clause.¹⁵⁰ At first glance, this appears to prove a reciprocal relationship between the OECD and the EU.¹⁵¹ The rule is aimed to prevent double non-taxation of dividends deriving from hybrid loan arrangements and shall prevent cross-border companies from planning their intra-group payments so as to result in double non-taxation.¹⁵² The revised version of Article 4 (1) (a) reads as follows:

The Member State of the parent company shall

“Refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary.”¹⁵³

Hence, the state of the parent company is basically forced to tax profits that were deductible in the state of the subsidiary, which leaves any tax incentives granted by the subsidiary state without effect. In fact, the rule causes a burden to the taxpayer, as he cannot benefit from intended tax exemptions anymore and is in so far treated worse than before. In the author’s view, this provision clearly interferes with the intended aim of the PSD, which is inter alia designed to ensure that the effective functioning of an internal market is not hampered by restrictions, distortions or disadvantages arising from tax provisions.¹⁵⁴

Moreover, there remain some loopholes, which allow the taxpayer to avoid application of the linking rule. Since the scope of the PSD is limited to sharehold-

¹⁴⁸ B. Terra, J. Kajus, *Tackling Tax Avoidance: Commission tightens key EU corporate tax rules*, 2013; E. Eberhartinger, M. Six, *Taxation of Cross-Border Hybrid Finance: A Legal Analysis*, 2009, p. 14.

¹⁴⁹ T. Hagemann, C. Kahlenberg, *Sekundärrechtliche Reaktionen auf aggressive Steuerplanungsaktivitäten - Änderung der Mutter-Tochter-Richtlinie*, 2014, Ch. 1.

¹⁵⁰ H. van den Hurk, *Proposed Amended Parent-Subsidiary Directive Reveals the European Commission’s Lack of Vision*, p. 488, 2014.

¹⁵¹ A. P. Dourado, *Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6*, p. 51, 2015.

¹⁵² Council of the European Union, 11647/14, p.1, 2014.

¹⁵³ Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, 2014.

¹⁵⁴ Council Directive 2011/96/EU of 30 November 2011, preamble par. (4).

ings of at least 10 %, the Directive has no effect on companies with a lower shareholding. Correspondingly, it may be conceiving that companies shift investments only to their minority shareholdings in order to avoid application of the linking rule. As a second concern, the scope of applicability is evidently limited to EU Member States. Thus, companies may likely structure their investments beyond EU borders to dodge taxation.¹⁵⁵ Further, the PSD applies merely to “profit-distributions”, albeit there is no final definition of the term “profits” in the Directive. In that respect it is rather vague if hybrid payments may be considered as profits and would therefore be covered by the PSD.¹⁵⁶ However, in the authors opinion, a purposive interpretation of the rule will arguably leave no doubt, that hybrid instruments are also covered by the scope of the term. Moreover, the PSD pursues the aim to avoid “asymmetrical” tax treatment¹⁵⁷, which also supports the argument that hybrid payments fall in the scope of the Directive. On the same token the preamble of the amended Directive states explicitly that the benefits of the Directive shall not lead to unintended tax advantages such as double non-taxation.¹⁵⁸

Incidentally, the subject-to tax effect is limited to the scope of the PSD.¹⁵⁹

4.2.1 In Light of the OECD Proposals

Unlike the primary rule of the OECD recommendations, the PSD allocates the taxing right to the Member State of the parent company (e.g. the resident state). Again, the primary rule allocates the taxing right to the source state, to the extent that an income leads to non-inclusion in the resident state. On that note, the proposed provision of the PSD is rather akin to the secondary rule¹⁶⁰ of the OECD recommendations, which entitles the resident state to tax an item of income to the extent, that the income has already been subject to a deduction in the source state. However, while both rules allocate the taxing right to the resident state, there remain major differences in terms of the scope of the legislation.

Although E. Kokolia argues by implementing the OECD proposals EU Member States would not infringe EU law¹⁶¹, the author would abstain to jump to hasty conclusions. As already observed in the analysis of the German linking rule,

¹⁵⁵ See also: L. de Broe, *At Last, Some Output on the Fight against Double Non-taxation*, 2014, p. 311.

¹⁵⁶ E. Eberhartinger, M. Six, *Taxation of Cross-Border Hybrid Finance: A Legal Analysis*, 2009, p.14.

¹⁵⁷ C. Brokelind, *Swedish Supreme Administrative Court rejects reference to ECJ regarding application of EC Parent-Subsidiary Directive*, 2005, p. 327.

¹⁵⁸ Council Directive 2014/86/EU, 2014, preamble par. (2).

¹⁵⁹ L. de Broe, *At Last, Some Output on the Fight against Double Non-taxation*, 2014, p. 311.

¹⁶⁰ L. de Broe, *At Last, Some Output on the Fight against Double Non-taxation*, 2014, p. 311.

¹⁶¹ E. Kokolia, *BEPS Impact on EU Law/ Hybrid Payments and Abusive Tax Behaviour*, 2015, p. 151.

there are several solid objections to this legislation, which may likely violate EU law.

Initially, the PSD does only apply to related companies with a shareholding of at least 10 % within the EU.¹⁶² Contrary, the OECD rules require a minimum shareholding of at least 25 %¹⁶³, which narrows their scope. Thus, countries, which follow the OECD proposals, may likely infringe secondary EU law, since their provisions do not mitigate mismatches below 25 %, which is in clear conflict with the PSD.

As demonstrated above, there are further differences as regards the scope of both rules. Moreover, the OECD recommendations do not obtain any legal value, unless adapted to domestic law, while a Directive is legally binding to EU Member States. Thirdly, in return to what was already discussed previously¹⁶⁴, the defensive rule operates on the very edge to be considered as an obstacle to the fundamental freedoms.

4.2.2 Impact on EU Law

In response thereto, the question arises if this assumption might be different due to the fact that the EU itself now stipulates a similar provision in the PSD? One may argue that this is tantamount to a *carte blanche*, which feigns conformity with EU law of a measure that may otherwise be considered to violate EU law. This casts doubts on whether a directive can actually be contrary to primary EU law.

Arguably, there is a general assumption that Community measures are “in principle presumed to be lawful”.¹⁶⁵ In the “Ouzo”-case, the Court stated that a Directive remains in force unless it is withdrawn by the Council or declared invalid by the ECJ.¹⁶⁶ Also, In *Gaz de France*, the ECJ was asked whether a regulation of the PSD may be contrary to one of the fundamental freedoms.¹⁶⁷ In its ruling, the Court stated, that the

“Community legislature has wide discretion in relation to the harmonisation and approximation of legislation.”¹⁶⁸

This statement serves as an example, that the Court enjoys a broad margin, when it is asked to examine the validity of Community Law. In spite of that,

¹⁶² Council Directive 2011/96/EU of 30 Nov. 2011 on the common system of taxation appl. in the case of parent companies and subsidiaries of diff. Member States, Article 3 (1) (a) (i).

¹⁶³ OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 69.

¹⁶⁴ See ch. 3.3.3.

¹⁶⁵ C-475/01 *Commission v Hellenic Republic* [2004], par. 18.

¹⁶⁶ C-475/01 *Commission v Hellenic Republic* [2004], par. 22 f.

¹⁶⁷ C-247/08 *Gaz de France – Berliner Investissement SA v Bundeszentralamt für Steuern* [2009].

¹⁶⁸ *Ibid.*, par. 47.

even if not related to tax law, the Court declared the Data Retention Directive invalid¹⁶⁹ since it failed the proportionality test of the ECJ, which requires

"that acts of the EU institutions be appropriate for attaining the legitimate objectives pursued by the legislation at issue and do not exceed the limits of what is appropriate and necessary in order to achieve those objectives."¹⁷⁰

Remarkably enough, even if declared invalid, the national laws transposing the directive in other countries will remain valid until challenged by domestic courts.¹⁷¹ Acknowledging, the issue at hand is not to declare an entire Directive as invalid, but rather to contest a certain provision of a directive, it does still demonstrate that the Court happens to strike down EU legislation under certain, although limited, circumstances. On the other hand, the threshold for the ECJ to strike down supranational legislation is reserved for quite extreme situations.¹⁷²

It is thus difficult to assess, whether the ECJ may eventually strike down the linking rule of the PSD. In the authors view, even if there are valid legal concerns, this is rather unlikely since there are also political interests involved.

Another strait of the proposed rule is linked to the administrative constraints it may cause, which is already discussed earlier in this thesis. Again, the linking rule requires the resident state of the parent company to possess certain knowledge of the tax treatment in another Member State to decide if the linking rule applies. Firstly, it is yet unclear, who will actually bear the burden of proof. Is it for the Member State of the parent company to provide evidence for non-taxation in the source state or is it for the taxpayer? Secondly, how burdensome will the administrative work be to gather all the information required? At this place, one may keep in mind, that those administrative issues must not cause an excessive burden to the taxpayer.¹⁷³ This argument may yet be less valuable when the mutual assistance directive provides for the necessary information, which may justify an additional administrative burden.¹⁷⁴ Yet, the contrary is true if a third country is involved. Such a situation may still fall in the scope of free movement of capital, but the Mutual Assistance Directive would not be

¹⁶⁹ C-293/12 and C-594/12 *Digital Rights Ireland Ltd v Minister for Justice, Equality and Law Reform*, Ireland [2014].

¹⁷⁰ *Ibid.*, par. 46.

¹⁷¹ J. Scherer, C. Heinickel, *European Court of Justice Declares Data Retention Directive Invalid*, 2014, p. 3.

¹⁷² C-475/01 *Commission v Hellenic Republic* [2004], par. 20.

¹⁷³ *Joined Cases C-436/08 and C-437/08 Haribo Lakritzen Hans Riegel BetriebsgmbH v Finanzamt Linz* [2011], par. 104.

¹⁷⁴ See: B. J. M. Terra, P. J. Wattèl, *European Tax Law*, 2015, p. 91.

applicable and arguably not serve as a possible justification based on an excessive administrative burden.¹⁷⁵

Similarly, the linking rule may lead to contrary outcomes in respect to applicable bilateral tax treaties concluded between Member States. Tax Treaties do not yet include any provisions comparable to a linking rule. Therefore, states, which apply their tax treaties, do arguably infringe secondary EU law, unless the national measure provides for a treaty override, such as the German provision. A treaty override, however, leads to different issues in domestic law, though. At least the OECD acknowledges developing a consistent amendment of its MC in foreseeable future.¹⁷⁶

Conclusively, in terms of its wording and purpose, the new linking rule of the PSD is comparable to the defensive rule. However there are major differences as regards their legal binding force and their scope. Since the defensive rule may cause an obstacle to EU law, the author would rather recommend Member States to implement the new rules of the Directive, since the latter is also legally binding and the risk of jeopardizing EU law is diminished, but yet not entirely ruled out.

In so far, while the rule itself supports the aim of avoiding double non-taxation, further adjustments are necessary in order to safeguard its desired purpose.

Member States are called upon to implement the proposed legislation to domestic law before the end of 2015. It remains to be seen if the linking rule of the PSD will be challenged in front of the ECJ.

4.3 The Benchmark of Anti-Avoidance Legislation

Hybrid Mismatches are at the core of international tax planning, aimed to achieve double non-taxation. Since numerous tax-planning activities operate on the very edge of legal validity, it will be assessed if mismatch arrangements may be counteracted by anti-avoidance legislation. One may yet keep in mind that double non-taxation is not only desirable for taxpayers to reduce their tax burden, but also an intended tool of several countries to attract foreign investment. In response to that, certain states, the EU and the OECD do increasingly rely on Anti-Avoidance legislations.¹⁷⁷

To have a brief view on the terminology in the field of tax evasion and tax avoidance, it is beyond any doubt, that tax evasion constitutes illegal conduct¹⁷⁸, which is tantamount to abuse, whereas tax-avoidance operates in a legal

¹⁷⁵ N. Bammens, *The principle of non-discrimination in international and European tax law*, 2012, p. 798.

¹⁷⁶ A. P. Dourado, *Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6*, 2015, p. 51.

¹⁷⁷ M. Lang, *BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties*, 2014, p. 656.

¹⁷⁸ R. Russo, *Fundamentals of International Tax Planning*, 2007, P. 49.

grey area.¹⁷⁹ In general terms, tax planning is acceptable unless a certain threshold has been passed which would amount to abusive behaviour.¹⁸⁰ Thus, hybrid mismatch arrangements are located in this very area and it appears, both the EU and the OECD are in an endeavour to ascertain a borderline between legal and unlawful mismatch arrangements, which they define as “aggressive tax planning”.¹⁸¹ The meaning of aggressive tax planning remains yet uncertain and does arguably not comply with well-established jurisprudence in this area.¹⁸²

In fact, the European Council adopted a new anti-abuse rule in its PSD, which ensures that the benefits of the Directive are not granted to arrangements that are not “genuine”.¹⁸³ The provision does not only apply to hybrid mismatches, but also to any other arrangement, which is not genuine. An arrangement shall be regarded as not genuine

“to the extent that they are not put into place for valid commercial reasons which reflect economic reality.”¹⁸⁴

It follows that this rule may be classified as a GAAR.

In respect of GAARs it must however be said, that these are in all likelihood not capable of targeting hybrid mismatch situations. Hybrid mismatches are habitually in accordance with relevant domestic law and would thus not be in the scope of GAARs.¹⁸⁵ Moreover, they are generally the corollary of sheer legal gaps, which result in different treatment of the same tax object. Legal gaps may hardly be hurdled by GAARs, as there is no immediate connection to abuse of law.¹⁸⁶ Notably countries, which are not in the centre of economic world affairs, argue that anti-avoidance rules may also scare future investors away and hence reduce their income and in so far provide an opposite effect.¹⁸⁷

In the author’s view the new GAAR of the PSD will presumably not be capable to counter hybrid mismatch arrangements.

¹⁷⁹ R. Russo, *Fundamentals of International Tax Planning*, 2007, P. 49.

¹⁸⁰ C. Marchgraber, *Tackling Deduction and Non-Inclusion Schemes – The Proposal of the European Commission*, 2014, p. 133.

¹⁸¹ A. P. Dourado, *Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6*, 2014, p. 42 ff.

¹⁸² *Ibid.*, p. 44.

¹⁸³ Council Directive (EU) 2015/121 of 27 January 2015, amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, Art. 1 (2).

¹⁸⁴ *Ibid.*, Art. 1 (3).

¹⁸⁵ R. de Boer, *BEPS2, Neutralizing the Effects on Hybrid Mismatch Arrangements*, 2015, p. 16; L. de Broe, *At Last, Some Output on the Fight against Double Non-taxation*, 2014, p. 312.

¹⁸⁶ A. P. Dourado, *Aggressive Tax Planning in EU Law and in the Light of BEPS: The EC Recommendation on Aggressive Tax Planning and BEPS Actions 2 and 6*, p. 48.

¹⁸⁷ N. Boidman, M. Kandev, *The BEPS Deliverables: A Macro Critique*, 2014, p. 613.

As regards the OECD proposals, there is a conceptual feature, which extends the scope of the linking rules not only to related parties, but also to so-called “structured arrangements”.¹⁸⁸ Remarkably, the related-party requirement is abolished, when a structured arrangement is found to exist. Therefore any “structured arrangement” falls in the scope of the linking rules, irrespectively of any ownership test. The linking rule is specifically aimed to tackle deduction and no-inclusion arrangements and may therefore be classified as a Specific Anti Avoidance Rule (SAAR). A “structured” arrangement is defined as

“any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances (including the terms) of the arrangement indicate that it has been designed to produce a hybrid mismatch.”¹⁸⁹

Based on a literal interpretation, the use of the term “structured arrangement” is misplaced and confusing.¹⁹⁰ What does it contribute to the internationally well-accepted technical terms such as artificial arrangements, tax avoidance or genuine arrangements, which is inherent in the PSD? Additionally, it is utterly unclear what is meant by “priced into the terms”. Furthermore, the threshold to be considered as a structured arrangement appears to be very low. This is confirmed by a non-exhaustive list of examples, according to which for instance an arrangement “that is designed, or is part of a plan, to create a hybrid mismatch, constitutes a structured arrangement”.¹⁹¹ The wording is cloudy and will likely lead to arbitrary conclusions.

In the authors view, those are merely vague assumptions, which would lead to intense legal uncertainty in practice. According to constant law practice of the ECJ, a national anti-avoidance legislation causes a restriction to EU law, unless it is particular aimed to counter artificial arrangements.¹⁹² It follows, EU Member States, who choose to implement this proposal, will certainly put EU law into jeopardy. It is utterly unclear, why the OECD did not rely on the international accepted terms in this field.

On a related note, the deliverable on Action 6 proposes to implement a GAAR in the OECD Model Convention. Notwithstanding the previous arguments, adding a new rule to existing tax treaties bears always a risk, of an “a contrario”

¹⁸⁸ OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 54.

¹⁸⁹ OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 67.

¹⁹⁰ R. de Boer, O. Marres, BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements, p. 40, 2015: A. Schnitger, M. Weiss, Empfehlungen der OECD zu „Hybrid Mismatches“ für die nationale – Steuergesetzgebung, 2014, p. 510.

¹⁹¹ OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014 p. 68.

¹⁹² C-196/04 Cadbury Schweppes plc v Commissioners of Inland Revenue [2006], par. 51.

interpretation, as Lang argues. The result of which would be to argue that those new features of the new GAAR were not existent in previous treaties.¹⁹³

Conclusively, neither the GAARs nor the linking rules are, at this juncture, capable to mitigate mismatch arrangements.

4.4 Nexus between OECD and EU

The previous work did already give ground to believe that there is a lack of comprehensive reciprocal relationship between the work of the OECD and the EU. In fact the OECD Report on Hybrid mismatches does not contain any reference whatsoever to EU law.¹⁹⁴

In spite of that, the Council of the European Union recalls explicitly

“Its willingness to fight aggressive tax planning and base erosion and profit shifting at EU and international levels” and stresses that this work should consider the compatibility of on-going OECD work with the EU legal framework.¹⁹⁵

Therefore one is tempted to argue that the EU acts as a mere executive power, while the OECD is leading the way. In the authors view this statement is yet not beneficial from a EU perspective. One may likely interpret it in a way, according to which the EU would transfer its juridical competence in this area to the OECD, which would be in clear conflict with the TFEU. Similarly the OECD itself is operating on the edge of their competence, when it brings in legislative proposals¹⁹⁶. One may even argue the OECD is acting *ultra vires*. Therefore the EU is well advised to become aware of its duties, which are not to carry out orders blindly. This is especially true, when those orders are given by international organisations without any juridical force.

At least, the OECD did lately factor EU law in their deliverables regarding base erosion. In fact, the report about CFC-rules takes special account of the peculiarities of EU law.¹⁹⁷ It acknowledges, that EU Member States may need to modify the recommendations to comply with EU law.¹⁹⁸ However, while this statement comes rather late in terms of the BEPS project, one may question whether the OECD would be prepared to redraft their preceding deliverables by taking due care of EU law.

¹⁹³ M. Lang, BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties, 2014, p. 656.

¹⁹⁴ R. de Boer, BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements, 2015, p.33.

¹⁹⁵ Council of the European Union, Draft Statements, 2013/0400 (CNS), 2013.

¹⁹⁶ L. Hinnekens, Overview of New Paths and Patters in EU Tax Development with Focus on EU Soft Law and External Factors, 2014, p. 255.

¹⁹⁷ OECD, BEPS Action 3: Strengthening CFC Rules, 2015, p. 9.

¹⁹⁸ *Ibid*, p. 10.

5 Alternative Remedies

The previous assessment did demonstrate, that linking rules might from a theoretical perspective be capable to safeguard taxation of an item of income and hence mitigate double non-taxation. But it is also obvious that these rules entail a number of shortcomings. They must be highly sophisticated in order to be both effective and in compliance with domestic and EU law. To be thoroughly enforceable, the recommendations must be followed by all Member States, which may likely require several years.¹⁹⁹ Along with that, from a global point of view it is truly necessary that non-member countries should also follow those recommendations in order to avoid exploitation of loopholes.²⁰⁰ It is however still an issue that the proclaimed shareholding varies between the OECD recommendations, domestic law systems and the EU proposals, which leads to uncertainty. The proposed Linking Rules do also cause a high administrative burden to all the Member States concerned, since they require an in depth understanding of foreign tax legislation. Surprisingly, the OECD did not by any means refer to this issue in their recommendations. However the published CFC deliverable devotes a special topic to the compliance with EU law and the issue of administrative burden.²⁰¹ Some authors argue linking rules serve as a cautionary tale on the intricacy of those rules.²⁰² One of the arguments M. Lang makes, is that a rule, which is subject to the condition of a certain tax treatment in another country, may not serve the aim of creating a single market. Moreover, he favours a per-country approach, although admitting that there may arise some negative short-term effects, such as double non-taxation. Still, in the long run, it will provide sufficient remedy, due to the pressure, which arises on the legislator as a consequence of those negative effects.²⁰³

Scholars do therefore discuss alternative means to mitigate base erosion and double non-taxation.

Most likely, the cure-all remedy to counter all drawbacks of cross-border taxation will be a harmonized tax system.²⁰⁴ While the OECD does also briefly discuss this approach, it is basically forthwith abolished due to its high complexity, considering it not to be achievable at this point.²⁰⁵ On the same token, abolishment of the debt-equity bias will arguably finally resolve the issue, since no qualification conflict can arise anymore.

¹⁹⁹ A. Contrino, BEPS: Is International Tax Planning Over? 2014, p. 841.

²⁰⁰ A. P. Dourado, Base Erosion and Profit Shifting (BEPS) Initiative u. Analysis, 2015, p. 3.

²⁰¹ OECD, BEPS Action 3: Strengthening CFC Rules, 2015, p. 11.

²⁰² A. Schnitger, M. Weiss, Empfehlungen der OECD zu „Hybrid Mismatches“ für die nationale – Steuergesetzgebung, CH .3.1.

²⁰³ M. Lang, ECJ case law on cross-border dividend taxation ± recent developments, 2008, p.72.

²⁰⁴ See also: S. E. Bärsch, C. Spengel, Hybrid Mismatch Arrangements: OECD Recommendations and German Practice, 2013, p. 525.

²⁰⁵ See also: L. Hinnekens, Overview of New Paths and Patters in EU Tax Development with Focus on EU Soft Law and External Factors (Part 1), 2014, p. 248.

As previously discussed, some authors view GAARs as a conceivable remedy. Again, the author does not share this opinion. A former German constitutional Court judge stated, that a good lawyer may not need an anti-abuse rule.²⁰⁶

Therefore, the author will briefly focus on CFC rules as an example of Specific Anti Avoidance rules²⁰⁷ and State aid proceedings as a credible legal remedy.

5.1 CFC Legislation

It is argued that effective CFC regimes, enforced by the country of residence, may resolve the issue of double non-taxation, too.²⁰⁸ CFC rules are aimed at preventing deferral or denial of taxation by shifting profits to a CFC²⁰⁹ and thus limiting the deductibility of interest in certain offshore investment situations. While the scope of CFC rules compared to the alleged linking rules is limited to interest expenses, hybrid mismatches do in the vast majority of cases only occur in the context of interest payments.²¹⁰ It follows that CFC rules may also be auspicious in the fight against base erosion, since they protect the tax base of the residence country. There are also positive “spill-over” effects on source countries, as taxpayers have no incentive to invest in low-tax jurisdiction, anymore.²¹¹

The main drawbacks of CFC rules are yet, that countries apply broad exceptions to their CFC regimes, which makes their circumvention quite accessible for MNEs. This is especially true for the US CFC regime, which is incapable of taxing the profits of enterprises like Apple, Starbucks and others due to the granted exceptions.²¹² Therefore, CFC rules are on the agenda of Action 3 of the OECD, which is aimed at strengthening CFC legislation.²¹³

Another drawback is, that CFC rules may also cover genuine transactions, which is why their scope in a EU context must be limited to wholly artificial arrangements, as confirmed by the ECJ in *Cadbury Schweppes*.²¹⁴

Thus, if carefully drafted, CFC rules may serve as a useful remedy against base erosion, too. Even if not subject to deeper investigation, CFC rules as compared to linking rules, are easier to administer, not least because they are already widely accepted.

²⁰⁶ M. Lang, BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties, 2014, p. 658.

²⁰⁷ L. de Broe, At Last, Some Output on the Fight against Double Non-taxation, 2014, p. 311 f.

²⁰⁸ See also: OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014, p. 49.

²⁰⁹ A. Ting, iTax - Apple's Int. Tax Structure and the Double Non-Taxation Issue, 2015, p. 6.

²¹⁰ R. de Boer, O. Marres, BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements, 2015, p. 40.

²¹¹ A. Ting, iTax - Apple's Int. Tax Structure and the Double Non-Taxation Issue, 2015 p. 6.

²¹² Ibid. 2015, p. 6.

²¹³ OECD, BEPS Action 3: Strengthening CFC Rules, 2015.

²¹⁴ C-196/04 *Cadbury Schweppes plc v Commissioners of Inland Revenue* [2006], para. 54.

As mentioned previously the OECD proposals as regards CFC rules are arguably better drafted, since it appears that the OECD takes due care of the constraints, which EU law may impose on CFC rules.

5.2 State Aid

While all the measures proposed up to this point are predominantly aimed at restricting inadmissible conduct of the taxpayer, one may again evoke that double non taxation and double deductions are not merely the result of tax planning activities but also intended tools by certain states. As follows, it is inappropriate to blame only taxpayers for the alleged loss of tax revenue. State Aid measures²¹⁵ serve therefore as appropriate means to investigate on states if offered tax incentives lead to harmful tax competition. In 2014, the Commission started several state aid proceedings against measures, which favour tax arbitrage of MNEs. According to the Commission MNEs were excessively or unfairly reducing their global tax burden by taking advantage of intentionally granted tax incentives.²¹⁶ Especially internationally accepted principles, such as the single tax-principle serve as a tool to check a domestic tax system against its own principles.²¹⁷ One of the benefits in favour of state aid proceedings is, that those can not only be applied against a tax scheme in general, but also and more important against certain individual tax rulings, since those demonstrate how the law is enforced and that possible discretionary treatment leads to an assumption of state aid.²¹⁸ Noteworthy, state aid decisions bear a retrospective effect, which means, that the Commission will order the recovery of any granted tax benefit and interest thereof.²¹⁹

Albeit not subject to deeper investigation, State Aid measures would likely be capable to counter the negative outcomes of harmful tax competition, too.

6 Final Remarks

This inquiry assessed linking rules against various legal benchmarks and examined their legal compliance and capability.

Based on the previous analysis, the primary and the secondary rule entail numerous risks to infringe EU law. This is especially true in respect of the secondary rule as incorporated into German Law, since it does not achieve its intended aim as prescribed by the German legislator. It follows that uniform integration of the proposed measures arguably exacerbates the situation even more, since domestic legal systems make those rules subject to various other conditions of their national legal frameworks. Furthermore, Member States are at

²¹⁵ Article 107 ff. TFEU.

²¹⁶ P. Rossi-Maccanico, *Fiscal State Aids, Tax Base Erosion and Profit Shifting*, 2015, p. 64.

²¹⁷ P. Rossi-Maccanico, *Fiscal State Aids, Tax Base Erosion and Profit Shifting*, 2015, p. 65.

²¹⁸ P. Rossi-Maccanico, *Fiscal State Aids, Tax Base Erosion and Profit Shifting*, 2015, p. 74.

²¹⁹ P. Rossi-Maccanico, *Fiscal State Aids, Tax Base Erosion and Profit Shifting*, 2015, p. 75.

liberty to amend those rules at their discretion, which would likely cause further disorder. Consequently, one of the greatest weaknesses of the OECD recommendations is nonetheless the lack of legal value and enforceability.

For those reasons, the author argues that organisations without juridical power, act *ultra vires* and should restrain from proposing legal measures such as linking rules.

To this end, the new linking rule as incorporated in the PSD is legally binding to EU Member States, which makes it also uniformly enforceable. Although equipped with legal force, this provision does still not resolve the issue as regards compliance with EU law. Similar to the observations made in respect of the secondary rule, there remain grounds to believe that this provision is threatening conformity with primary EU law.

While the author confesses that linking rules may – theoretically – be capable to mitigate double non-taxation, since they take account of the single tax principle, there are various drawbacks, which eventually render them infeasible. Establishing a new law does only make sense if their benefits outweigh their drawbacks, though.²²⁰

In particular the work on “Aggressive Tax Planning” is ill defined and contains a number of terms, which are ambiguous and hard to align to already established concepts in this area.

Instead, alternative countermeasures, such as State Aid proceedings and CFC rules appear auspicious to mitigate double non-taxation and do not suffer from comparable dilemmas. Clearly, CFC and State Aid measures are already well established in international and European legal practice and require only minor adjustments to be immediately enforceable.

²²⁰ M. Lang, BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties, 2014. p. 656.

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