



Lund University

School of Economics and Management
Department of Business Law

Hybrid Mismatch Arrangements Within EU: Under what Conditions could Single Taxation Be Secured?

by

Margret Agusta Sigurdardottir

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Supervisor: Cécile Brokelind

Examiner: Axel Hilling

Author's contact information:

E-mail address: mas13@hi.is

Telephone numbers: +46-(0)-72-972-0464 / +354-868-1082

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SUMMARY

The purpose of the thesis is to analyse the problems of hybrid mismatch arrangements within the EU and how single taxation, which requires income to be taxed once, not more or less, can be secured under EU law.

After the amendments of the PSD, where an anti-hybrid rule was enacted, the legal environment for companies within the European Union changed. Parent companies are now punished by using, regardless of the purpose behind the arrangements, disparities of jurisdictions between Member States. Participation exemption of dividends is after the amendments disallowed in accordance to Article 4.1(1) of the PSD, if a payment, on the other hand, is deductible as interest expenses in the subsidiary State. The Council, as well as the Commission, is certain that mismatch arrangements create an obstacle for the internal market, but such an assessment is doubtful. For instance has the ECJ ruled in its judgments that juridical double taxation is not an obstacle which restricts or discriminates the TFEU fundamental freedoms. By analogy, the same should apply for double non-taxation. The Court has not agreed on that a Member State is obliged to take into consideration the deviating tax treatment of the another Member State, which is exactly what the PSD anti-hybrid rule requires the parent State to do.

A lack of a subjective measure within the anti-hybrid rule results in arrangements which are reflecting economic reality and commercially justified are captured by the rule. Interestingly, this is not considered by the EU legislators to be an obstacle to the internal market. This is contrary to various judgements of the Court where it has been concluded that Member States cannot enact measures in a general manner which presume tax avoidance. It is according to the Court only justified to restrict the freedoms provided in the TFEU if the arrangements are wholly artificial, as well as proportionate. However, that is not the case with the anti-hybrid rule and an attempt was made in this thesis to find a solution which does not infringe EU law. The single taxation will play a key role and therefore, it will be examined under which conditions single taxation can be secured when counteracting hybrid mismatch arrangements within the Union.

ABBREVIATION LIST

AG	Advocate General
ATA Directive	ATA Directive Proposal
BEPS	Base Erosion and Profit Shifting
CCCTB	Common Consolidated Corporate Tax Base
Commission	European Commission
ECJ	Court of Justice of the European Union
EEA Agreement	European Economic Area Agreement
EFTA	European Free Trade Association
EU	European Union
GAAR	General Anti-Abuse Rule
Ibid.	Ibidem
IRD	Interest-Royalty Directive
MNEs	Multinational Enterprises
OECD	The Organization for Economic Co-operation and Development
p.	Page(s)
para./paras.	Paragraph/paragraphs
PSD	Parent-Subsidiary Directive
SAAR	Special Anti-Abuse Rule
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
v.	Versus
Vol.	Volume

1 Introduction

1.1 Background

Hybrid mismatch arrangements exploit differences in tax treatment of companies or instruments under the law of two or more tax jurisdictions resulting in double non-taxation, including long-term deferral. The need to apply general criteria in characterization of hybrid arrangements opens up opportunities and risks for aggressive tax planning.¹ These types of arrangements have been increasing and are widespread over the world which results in a substantial erosion of taxable bases of the countries concerned.² The collective tax base of countries is therefore put at risk through the operation of hybrid mismatch arrangements despite the problem of determining which country has lost tax revenues under the arrangement. Apart from impacting on tax revenues, hybrid mismatch arrangements have also been considered to have a negative impact on competition, efficiency, transparency and fairness.³ Arrangements, which take advantages of mismatches between jurisdictions, increase the risk that single taxation is not secured.

From a European Union (EU) perspective, taxation power of Member States is characterized by its sovereignty and protected as such. Taxation has a determining effect in the means of financing national budgets including deciding economic policy. An important feature of taxation policy can also be seen as a competition instrument which has been increasing within the EU Member States for the last few decades. The increase in cross-border investments has given Multinationals enterprises (MNE's) opportunities to use hybrid financial instruments taking advantages of mismatches of different national tax treatments and from international standard rules to relieve double taxation. This has been considered to lead to a distortion of competition between cross-border and national groups, contrary to the scope of the Parent-Subsidiary Directive (PSD).⁴ For this reason, in 2014, the Council proposed a directive amending the PSD to counteract hybrid financial instrument where all Member States should have adopted the amendments by the end of year 2015.⁵

Moreover, the Organization for Economic Co-operation and Development (OECD) recommends in the project of Base Erosion and Profit Shifting (BEPS) Action 2 for countries to enact *linking rules* (anti-hybrid rules) to counteract hybrid mismatch arrangements.⁶ The recommendations have relevance within the EU since a majority of EU Member States are members of the OECD.⁷ The recommended rules authorize the source State to deny deduction because of a lack of taxation in the income recipient's State (*primary rule*) and if this right is not exercised, the rules allow the resident State of the income beneficiary to deny

¹ E. Eberhartinger & M.A. Six, 'Taxation of Cross-Border Hybrid Finance: A Legal Analysis', (2009) Intertax, Vol. 37, Issue 1, p. 4.

² OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, p. 13.

³ OECD (2012), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, OECD Publishing, p. 11.

⁴ Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 345, 29.12.2011, p. 8).

⁵ Council Directive 2014/86/EU of 8 July 2014 of amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 219, 25.7.2014, p. 40-41).

⁶ OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, p. 12.

⁷ Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, United Kingdom.

exemption/non-inclusion in the domestic tax base (*defensive rule*).⁸ The amended Article 4 of the PSD relies upon the defensive rule where the Member State of the parent refuses to exempt the payment from dividend taxation. The Anti-Tax Avoidance Directive proposal (ATA Directive),⁹ on the contrary, capitalizes on rules where the Member State of the parent shall follow up the classification of the hybrid instrument in accordance with the legislation of the subsidiary State.

The anti-hybrid rules are known as linking rules or co-ordination rules as they rely on the correspondence principle, where Member States are obliged to take into consideration deviating tax consequences of another Member State. Tons of questions remain unanswered as well as if the sovereignty of Member States might be threatened by harmonized tax measure combatting hybrid arrangements including whether the PSD anti-hybrid rule is in line with EU law.

The principle of single taxation is one of the fundamental international tax principles and provides the underlying element of avoiding both double taxation and double non-taxation. For the principle to not infringe EU law, it is therefore necessary to examine the hybrid mismatch legislations such as those provided in the PSD and under which conditions single taxation can be secured.

1.2 Aim

The primary purpose of the thesis is to examine under which conditions single taxation can be secured under EU law regarding hybrid mismatch arrangements. This underlying aim however raises questions that need to be answered and examined before any conclusions will be made about the single tax principle. For this reason, the thesis will first examine whether double non-taxation should be considered to be a problem within the Union; second, whether national rules based on Article 4.1(a) PSD infringe EU law and if so, whether the measure can be justified and hence proportionate and third, whether switching from the exemption method to the credit would be a more feasible option.

ECJ case law will be scrutinized and by analogy, this will hopefully lead to an answer whether and why double non-taxation should be a problem within the EU. For answering the questions, the Treaty on the Functioning of the European Union (TFEU) fundamental freedoms and justifications reasons for discriminatory and/or restrictive measures enacted by Member States will be analysed. The most relevant approach (the per-country approach or the overall approach) has to be chosen to identify if there is a potential breach of EU law or not. For the third question, the credit method will be scrutinized and it will be examined how the method interacts with the European landscape. After answering these three questions, it will be examined if the single tax principle¹⁰ can be applicable in the conflict of hybrid mismatches between jurisdictions, hence avoiding both double taxation and double non-taxation. Consequently, the fundamental question of the thesis will be answered; under which conditions can the single tax principle apply in accordance to EU law and well-established ECJ case law.

⁸ C. Brokelind, 'Legal Issues in Respect of the Changes to the Parent-Subsidiary Directive as a Follow-Up of the BEPS Project' (2015) Intertax, Vol. 43, Issue 12, p. 818.

⁹ Commission, 'Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market' COM(2016) 26 final, cf. Article 10.

¹⁰ Reuven S.Avi-Yonah, *Advanced Introduction to International Tax Law*, (Edward Elgar Publishing 2015), p. 59.

1.3 Method and material

The research method adopted in the thesis will be the examination of the law as it stands in accordance with the *legal-dogmatic method*, which is also in line with how the ECJ reconcile rules and principles of international law.¹¹ Thus, the following research will inter alia embrace the internal perspective¹² which elucidates the essay topic from a legal point of view. ECJ case law will be analysed with the aim of understanding how the Court interprets the freedoms provisions.¹³ The law to be observed includes international fundamental tax principles, tax treaty law, primary EU (TFEU) and secondary law (PSD/IRD) as well as written and unwritten principles established by the Court.¹⁴ Even though soft law are instruments that does not have binding effects it may however construe certain concepts enacted in hard law or unwritten principles and therefore advocate with the legal interpretation. Such is relevant regarding BEPS Action 2 including the OECD MC (OECD Model Convention) Commentaries as well as communications, recommendations and legislative history of Councils proposals of directives may produce some legal effect through general principles of law.¹⁵

Despite the fact that the ECJ has not yet rendered a judgement based on the PSD anti-hybrid rule, the analysis relies primarily on comparable case law which can, by analogy, be addressed under the anti-hybrid rule. Along with case law examination, a doctrinal articles and scholar literatures will play an important role. Articles and scholar literature where chosen by relevancy of the thesis subject and solely leaned on international recognized journals and literature edited or written by well-known scholars in the academic world. These sources were examined with an objective critical view. The discussion of case law mostly deals with cross-border dividends cases that either regards the freedom of establishment or the free the movement of capital or both. Cases that indicate whether the Court is willing to take the deviating tax consequences in the other Member State into considerations or not will be scrutinized and criticized. Such cases are highly relevant since Article 4.1(a) PSD relies up on the tax consequences in the other State. In the end of the thesis, a proposal will be made of potential solutions of the problem where the author tries to take everything that has been discussed and argued together and attempts to come to an independent, as well as objective and critical, conclusion.

1.4 Delimitation

The spectrum of hybrid financial instruments (*mezzanine finance*) ranges from company shares with typical loans features to loans with features which normally are associated with equity investments.¹⁶ In reality, everything between debt and equity can be considered as hybrid instrument.¹⁷ Hybrid mismatches can occur in number of situations and not only of different treatment of instrument but also from different treatment of company forms where

¹¹ Sjoerd Douma, *Legal Research in International and EU Tax Law*, (Kluwer Law 2014), p. 39.

¹² *Ibid*, p. 17-19.

¹³ Article 19 TEU.

¹⁴ Sjoerd Douma, *Legal Research in International and EU Tax Law*, (Kluwer Law 2014), p. 21.

¹⁵ *Ibid*, p. 21 and 37.

¹⁶ E. Eberhartinger & M.A. Six, 'Taxation of Cross-Border Hybrid Finance: A Legal Analysis', (2009) Intertax, Vol. 37, Issue 1, p. 4.

¹⁷ For instance jouissance rights, silent partnerships, participating bonds, convertible bonds, warrant bonds, profit participation loans and preference shares. Derivatives have under some conditions been considered as hybrid instruments (options, future, swaps) but in this paper the term hybrid instrument will not include such.

one jurisdiction classifies the company as transparent while the other jurisdiction classifies it as non-transparent (*hybrid entities*). The substance of the thesis will focus on dividends situations as provided in Article 4.1(a) PSD and hence not on the ATA Directive proposal, which will however have relevance in the thesis discussion and conclusion. The topic will stem from hybrid financial instruments where the focus will be on *deduction/non-inclusion schemes* and hybrid entities will be excluded. Despite the possibility that the hybrid mismatch problem could be solved with a Common Consolidated Corporation Tax Base (CCCTB), this discussion will however be left out of the consideration as well as political affairs. Obligations and administrative procedures of the Member State of the parent will also be left out of discussion including potential conflicts between the PSD and the ATA Directive proposal. Furthermore, the new general anti-abuse rule (GAAR) in the PSD, likewise the GAAR introduced in the ATA Directive proposal, will not be discussed or examined in a detailed manner.

1.5 Outline

In the beginning of Chapter 2, hybrid mismatch arrangements are described in general manner. The arrangements are thereafter addressed into the EU legal framework. Hence, the PSD anti-hybrid rule will be introduced and criticised, with a general discussion of the debt/equity bias.

Chapter 3 is the main substance of the essay where the question is answered whether double non-taxation is contrary to the internal market and if Article 4.1(a) PSD violates EU law or not. ECJ case law will be examined as well the fundamental freedoms in the search for answers, including if a national measure based on the PSD anti-hybrid rule could be justified under the rule of reason. Moreover, the possibility of switching over from exemption method to the credit will be analysed as well as the international fundamental tax principles will be discussed under its own heading. In the end, the problem will be addressed under the single tax principle and analysed.

Recommendations for a solution are laid down in Chapter 4. This chapter is therefore the fundamental part of the paper and contains a proposal to a solution of under which conditions single taxation can be secured regarding hybrid mismatch arrangements within EU law. In Chapter 5, the conclusions will be taken all together in a short compilation.

2 Hybrid Mismatch Arrangements within EU

Double non-taxation may take various forms. In cross-border situations, double non-taxation can occur when income, which is not taxed in the source State, is exempt in the resident State resulting in the income not being taxed anywhere. In more advantageous tax situations, double non-taxation can lead to more than just non-taxation. This is the case, for example, in deduction/non-inclusion scheme where a payment is deductible in the source State (*the subsidiary*) and non-taxable in the resident State (*the parent company*). Including double deduction schemes (“*double dip*”) where the same loss is deducted both in the State of source and of residence.

In general, the term hybrid mismatch describes arrangements between members of MNE’s or unrelated parties, which enter into arrangements to exploit asymmetries between different tax jurisdictions. These mismatches can arise both within a single tax regime and in a cross-border situation resulting in a double non-taxation including a long-term tax deferral. For this

reason, hybrid mismatches are the consequences of differences in the legal classifications of financial instruments or entities when two legal systems interact.¹⁸ It is a fact that taxpayers, which are engaged in cross-border structures, *may* take advantage of such *disparities* amongst national tax systems and therefore reduce their overall tax payments. On the other hand, these kinds of structures can be logical from the view of the taxpayers' business activities and a part of normal infrastructures of companies practising within certain industry sectors. Consequently, there can be an actual motive for companies to practice within two or more different jurisdictions where tax planning motivations are neither dominant nor the main cause. For States, however, the inconsistent classifications of hybrid financial instruments may lead to double non-taxation, depending on the actual content and impact of the national legislation and the instrument in question, which ultimately results in loss of state revenue.¹⁹

There is no common understanding of how equity or debt should be defined for tax purposes.²⁰ The fundamental difference between loan and equity capital is the tax treatment of the companies involved, including the contributors of its capital.²¹ According to the principle of *financial freedom*, every company is normally free to decide what kind of capital would primarily be more feasible to use to finance its activities. In addition, companies finance themselves either with equity from their shareholders or debt. Debt financing has, so far, been considered to be a more feasible option since interest paid of a loan capital is deductible for the debtor whereas the return on an equity investment is a non-deductible dividend. Interest and dividend are therefore treated differently for tax purpose resulting in that the payment lacks neutrality.²² Hence, in cross-border situations, the main component of tax revenues from interest is realized in the residence State of the interest recipient (*parent company*), whereas the main component tax revenues from dividends is realized in the State from which the dividends are paid (*subsidiary*).²³ For this reason, companies have a definitive tax incentive to finance themselves with debts rather than equity and when countries classify income differently it can be easy for taxpayers to circumvent benefits from one jurisdiction to another resulting with double non-taxation.

Within EU Member States there is little support for the idea that every financial instrument, hybrid or not, issued by companies within EU should be classified in the exact same manner in all Member States.²⁴ Indeed, the problem of classification inconsistencies is an issue within EU but that does not change the fact that economic and juridical double taxation due to classification conflicts are the result of different tax law of Member States. Such disparity, however, falls out of the scope of the TFEU as will be discussed later in the thesis (3.2.3).

¹⁸ Commission, 'Proposal for Council Directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States' COM(2013) 814 final, p. 5.

¹⁹ *Ibid.*, p. 6.

²⁰ Christian Kahlenberg and Agnieszka Kopec, 'Hybrid Mismatch Arrangements – A Myth or a Problem Still Exists?' (2016) *World Tax Journal*, Vol. 8, Issue 1, p. 209.

²¹ OECD. (2015), *Model Tax Convention on Income and on Capital 2014* (Full Version), OECD Publishing, p. R(4)-5.

²² M. Helminen, 'Classification of Cross-Border Payments on Hybrid Instruments', (2004) *Bulleting for International Taxation*, Vol. 58, No 2, p. 56.

²³ *Ibid.*

²⁴ J. Bundgard, 'Hybrid Financial Instrument and Primary EU Law – Part 1', (2013) *European Taxation*, Vol. 53. No 11, p. 544.

2.1 The Meaning of Hybrid Financial Instruments

As no general definition of the term “*hybrid financial instruments*” exists, various attempts have been made in the doctrine with the aim of establishing a common definition.²⁵ By referring to several literatures and scholars,²⁶ two definitions can be identified; a broad and a narrow approach. Under the former one, the term contains only certain components of both debt and equity capital.²⁷ By contrast, the latter defines the instruments as a mixed form between debt and equity capital.²⁸ A strict approach, that will narrow the debt and equity concepts in detail, is very difficult and could lead as well to different tax treatments of the same financial instrument between two or more jurisdictions.²⁹

The BEPS Action 2 Final Report does not refer to any particular features of financial instruments that make it hybrid since there is a wide variety of financial instruments and different ways to characterize them.³⁰ According to the Report, financial instruments treated for tax purposes make it impossible to “*comprehensively and accurately identify all the situations where a payment under the instrument can give rise to a hybrid mismatch.*”³¹ In this context, there is no palpable definition of the term hybrid financial instrument given by the OECD in BEPS Action 2. However, the organization indirectly defines the term as instruments with hybrid elements that *may* produce a deduction/non-inclusion outcome as a result of the diverged tax characterization by the States affected.³² The Commentaries of the OECD MC does not add anything as the hybrid financing is described as “*some kind of hidden capitalization or hidden equity capitalization.*”³³

The PSD directive was amended in 2014 and an anti-hybrid rule was enacted as Article 4.1(a). The BEPS Action 2 slightly reflects in the amendments, which have the purpose of targeting two types of arrangements; namely double deduction and deduction/non-inclusion situations.³⁴ In the explanatory memorandum with the directive, hybrid loans arrangements are classified as financial instruments that have characteristics of both debt and equity that results in an unintended double non-taxation related to different characterization of the instrument between the subsidiary State and the Member State of the parent.

²⁵ Christian Kahlenberg and Agnieszka Kopec, ‘*Hybrid Mismatch Arrangements – A Myth or a Problem Still Exists?*’ (2016) World Tax Journal, Vol. 8, Issue 1, p. 39.

²⁶ D. Hariton, ‘*Distinguishing Between Equity and Debt in the New Financial Environment*’, (1994) Tax Law Review, Vol. 49, Issue 3, p. 499 et seq; H. Eber-Huber, *Hybrid Financing*, (1996) IBFD, p. 8; H. Doornbusch & A. Kramer, ‘*The combined benefits of classification*’, (1998) International Tax Review, p. 27; M. Helminen, ‘*Classification of Cross-Border Payments on Hybrid Instruments*’, (2004) Bulletin for International Taxation, Vol. 58, No 2, p. 56; E. Eberhartinger & M.A. Six, ‘*Taxation of Cross-Border Hybrid Finance: A Legal Analysis*’, (2009) Intertax, Vol 37, Issue 1, p. 4 et seq.

²⁷ Ibid.

²⁸ Ibid.

²⁹ Christian Kahlenberg and Agnieszka Kopec, ‘*Hybrid Mismatch Arrangements – A Myth or a Problem Still Exists?*’ (2016) World Tax Journal, Vol. 8, Issue 1, p. 40.

³⁰ OECD. (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, para. 20, p. 25.

³¹ Ibid.

³² Ibid, paras. 13-14, p. 18 and para. 20, p. 25.

³³ OECD. (2015), *Model Tax Convention on Income and on Capital 2014* (Full Version), OECD Publishing, p. R(4)-5.

³⁴ C. Brokelind, ‘*Legal Issues in Respect of the Changes to the Parent-Subsidiary Directive as a Follow-Up of the BEPS Project*’, (2015) Intertax, Vol. 43, Issue 12, p. 818.

The reason for the difficulties of defining the term “*hybrid financing instruments*” is because of a broad distinction between equity and debt financing, which often is quite blurred. For instance, creditors may at some stage be able to convert their debt into a participation in the equity of the company or the interest which they are entitled to receive may be closely dependant on the profits made by the company.³⁵ It is therefore difficult to classify the financing as purely debt finance or purely equity finance. As a result, what is essentially considered to be an equity capital in one jurisdiction may possibly be disguised as debt in another jurisdiction and hence be efficient tool in aggressive tax planning of MNEs.

2.2 The PSD Amendments

The Council Directive 2011/96/EU,³⁶ which replaced Council Directive 90/435/EEC,³⁷ exempts dividends and other profit distributions paid by subsidiaries to their parent companies from withholding taxes and therefore eliminates double taxation of such income at the level of the parent company. The exemption method provided for under the Directive, and widely used by Member States, opened possibilities for tax arbitrage leading to double non-taxation by using hybrid instruments. To tackle such hybrid loans and mismatches the Commission made a proposal to amend the PSD on the 25th of November 2013, based on Article 115 TFEU.³⁸ The purpose of the amendments was to exclude benefits that lead to situations of double non-taxation and would therefore generate unintended tax advantage for MNE’s within different Member States, compared to groups of companies of the same Member State.³⁹ For the purpose of avoiding such situations, deriving from mismatches in the tax treatment of profit distributions between Member States, the Member State of the receiving company⁴⁰ shall now *disallow* these companies to benefit from the tax exemption applied to received distributed profits, to the extent that such profits are deductible by the subsidiary of the parent company.⁴¹ Hence, the adopted amendments link the tax treatment in the State of the parent with the State of the subsidiary.

Few issues concerning the amendments can be argued. First to mention, the hybrid loan aspect of the amendments raises similar concerns to the linking rules recommendation of BEPS Action 2. Both BEPS Action 2 and the amendments of the PSD do not *only* apply for wholly artificial arrangements.⁴² The rules apply despite the fact that the arrangements are

³⁵ OECD. (2015), *Model Tax Convention on Income and on Capital 2014* (Full Version), OECD Publishing, Paris, p. R(4)-5.

³⁶ Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 345, 29.12.2011, p. 8).

³⁷ Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 225, 20.8.1990, p. 6).

³⁸ The proposal also required Member States to adopt a common GAAR clause, preventing the extending of the benefits of the directive to arrangements that did not reflect economic reality.

³⁹ Council Directive 2014/86/EU of 8 July 2014 of amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 219, 25.7.2014, p. 40-41).

⁴⁰ The receiving company is either the parent company or permanent establishment of the parent company, cf. Commission, ‘Proposal for Council Directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States’ COM(2013) 814 final, p.4.

⁴¹ Council Directive 2014/86/EU of 8 July 2014 of amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 219, 25.7.2014, p. 40-41).

⁴² For example, case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995, para. 55.

commercially justified. In 2015, the PSD was again amended where the Council proposed a GAAR for the Member States to adopt. However, the GAAR and the anti-hybrid rule are inconsistent. In accordance to Article 1.2 PSD Member States shall *not* grant the directive benefits to an arrangement or a series of arrangements which have been done for *the main purpose, or one of the main purposes*, of obtaining a *tax advantage* that defeats the object of the directive, and are *not genuine* with regard to all relevant facts and circumstances. For this reason, arrangements are not regarded as genuine to the extent if they are not put into place for valid commercial reasons which reflect economic reality. The substance of the GAAR provision cannot be found in the PSD anti-hybrid rule. The linkage between these two provisions leads to two different underlying purposes. With GAAR, the purpose of the arrangements needs to be measured in a subjective manner while the underlying rule of the anti-hybrid is objective. Indeed, these two different provisions have a common feature which is to counteract tax avoidance. The anti-hybrid rule is considered to be a special anti-abuse rule (SAAR) but why is a different characterization of income a tax avoidance? There must be some kind of substance needed to indicate that the transactions are made with the aim of avoiding taxes. The rule applies automatically even though the transactions between the parent and the subsidiary are genuine and underlying business reasons for the establishment in the current Member State. The ECJ has in its judgements⁴³ concluded that a national provision restricting the freedom of establishment may be justified where it specifically relates to *wholly artificial arrangements* aimed solely at escaping national tax normally due and where it does not go beyond what is necessary to achieve that purpose.

The anti-hybrid rule applies when double benefits arise, a hybrid financial instrument is deemed to be debt leading to deductible interest payments in the source State while the resident State treats it as non-deductible dividends.⁴⁴ The PSD anti-hybrid rule therefore target two types of arrangements, namely situations of double deduction and deduction/non-inclusion. In contrast to thin-capitalization rules, anti-hybrid rules do not reclassify the hybrid instrument from debt to equity or conversely.⁴⁵

After the amendments, Article 4.1(a) PSD relies upon the defensive rule (1.2) and the amendments are indeed extending the scope from former amendments made on the PSD 2011. With the 2011 Directive, obligations were levied on the parent company's State of qualifying income from partnerships according to its own domestic tax law (Article 4.2). Differences between these two provisions are that the parent company, in accordance to Article 4.1, is required to *prove* the extent of the subsidiary's liability in the other Member State, while according to Article 4.2 the Member State of the parent applies its own tax legislation to partnerships according to its own tax law.⁴⁶

3 From Juridical Double Taxation to Double Non-Taxation

States can levy taxes in conformity with their sovereignty which is the ultimate power, authority and jurisdiction a State has over persons and territories. It is however necessary that

⁴³ Ibid.

⁴⁴ Commission Staff Working Document, *Impact Assessment*, SWD(2013) 474 final (25 November 2013), para. 11, including the Explanatory Memorandum with the Council Directive proposal amending PSD 2011/96/EU.

⁴⁵ C. Brokelind, '*Legal Issues in Respect of the Changes to the Parent-Subsidiary Directive as a Follow-Up of the BEPS Project*', (2015) *Intertax*, Vol. 43, Issue 12, p. 818.

⁴⁶ Ibid.

a personal or an objective nexus exists between the taxpayer and the State. Such a connecting factor for individuals usually includes domicile, residence or citizenship.⁴⁷ For legal entities, the connecting factor is usually the place of establishment or the place of effective management. In accordance with the objective connecting factor it is normally sufficient that parts of the transaction or activity involves the taxing State or that the object of the action is, in some way or another, connected to the taxing State.⁴⁸ Countries, indeed, have an incentive to protect their revenues by taxing income attributable to their jurisdiction. However, the right to tax is not necessarily within the power of one jurisdiction; therefore taxing rights may overlap when taxpayers move between countries, do cross-borders business transactions, establish a company in another State et cetera. Hence, two or more jurisdictions, sharing the taxation, can be in full right to tax particular income resulting in juridical double taxation.

What defines international juridical double taxation is generally the imposition of *comparable taxes* in two or more States on the same taxpayer regarding the same tax subject and for identical periods.⁴⁹ For this reason, a vast majority of countries worldwide have done bilateral double taxation treaties⁵⁰ to prevent or avoid double taxation.⁵¹

3.1 The Cornerstone of International Tax Principles

The *League of Nations*⁵² began investigating the problems of juridical double taxation already the year 1923. The investigation resulted in a report that became one of the cornerstones of the international tax regime. The principles that were laid down in that report have now been established in over 3,000 tax treaties and in international tax laws of the major economies of the world.⁵³ Four well-known economists⁵⁴ prepared the report and after identifying the problem, two major contributions were made towards a solution. First, the resident State should *avoid* double taxation and the taxing power should *levy* with the source State. This principle is known as “*the first bite at the apple rule.*” Secondly, was the development of the *benefit principle* which today underlies most, if not all, tax treaties. The benefit principle requires active income to be taxed primarily in the source State while passive income should be taxed on a residence basis.⁵⁵ The entire international tax regime, as it is known today, is based on these particular principles along with *the single tax principle*. What is interesting about the single tax principle is that it denounces both double taxation and double non-taxation since income should always be taxed once, not twice or not at all. It indicates, for residents, that the residence jurisdiction should tax income, active or passive, that is not taxed by the source State under “*the first bite at the apple rule.*” For source jurisdiction, it suggests

⁴⁷ M. Lang, *Introduction to the Law of Double Taxation Convention*, (2nd Edn., IBFD 2013), p. 27.

⁴⁸ Ibid.

⁴⁹ E. Reimer and A. Rust, *Klaus Vogel on Double Taxation Conventions*, Vol. 1, (4th Edn., Kluwer Law 2015), para. 2, p. 12.

⁵⁰ It shall be kept in mind that the general principle is that double tax treaties cannot create tax liability.

⁵¹ Countries usually use the OECD MC for such treaties as fewer countries build on the UN MC.

⁵² The League of Nations was the forerunner of the United Nations and was established under the Treaty of Versailles after the World War I with the aim of promoting international cooperation and achieving peace and security. The League of Nations ceased its activities after failing to prevent the Second World War. United Nations officially came into existence in October 1945, after World War II.

⁵³ Reuven S. Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar Publishing 2015), p. 3.

⁵⁴ Professor Bruins from Netherlands, Professor Einaudi from Italy, Professor Seligman from the United States and Sir Josiah Stamp from the United Kingdom.

⁵⁵ Reuven S. Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar Publishing 2015), p. 4.

that withholding taxes should not be reduced unless it is clear that taxation based on residence will apply for passive income.⁵⁶

The application of *the single tax principle* by source jurisdictions was unequivocal in the first League of Nations model treaty from 1927, which contained a withholding tax on interest that was refunded to the taxpayer if he did certify that the income had been declared in the resident jurisdiction.⁵⁷ The benefits principle and the single tax principle are combined resulting in a tax regime in which double taxation and double non-taxation are firstly avoided by assigning to the source jurisdiction the right to tax active income and to the residence jurisdiction the right to tax passive income; and secondly, allowing the other jurisdiction to tax that income if the primary taxing jurisdiction curbs from taxing it.⁵⁸ This particular combination should result in all income being taxed once.⁵⁹ However, if the resident country applies a participation exemption scheme, like provided in the PSD, and a certain income is not taxed in the source State, such would lead to double non-taxation but switching from the exemption method to the underlying tax method (*credit*) may be considered a solution to that problem.⁶⁰

The leading rule of preventing international double taxation established in international tax law, as addressed in the OECD MC, is *the principle of source State taxation*⁶¹ and the responsibility to avoid double taxation lies in the hands of the resident State. This prevention is either achieved by exempting the foreign source income in order to promote capital import neutrality (*the exemption method*) or by crediting the foreign tax with capital export neutrality (*the credit method*).⁶²

If all countries would rather rely on the source principle instead of the resident principle, which allows worldwide income taxation of residences, juridical double taxation of the same income would decrease.⁶³ In fact, non-residents are taxed according to the source principle but in contrast, most countries within EU apply worldwide income taxation in accordance with the residence principle.

From an EU law perspective it has been debatable why the resident State tax foreign source income and why it applies worldwide taxation with relief by exemption or credit instead of relying on the source principle. Indeed, every resident State wants to tax the total ability to pay of its residents by not wanting to escape any relevant factor, positive or negative, for that ability.⁶⁴ As expected, Member States have their intention of protecting their revenues but however, that has never been accepted by the ECJ as a justification of restricting the fundamental freedoms provided in the TFEU.⁶⁵ It follows that it is necessary to observe how

⁵⁶ Ibid, p. 5.

⁵⁷ Ibid.

⁵⁸ Ibid, p. 60 and 108.

⁵⁹ Ibid, p. 60.

⁶⁰ Ibid, p. 52. The Court accepted switching over from exemption to the credit method in case C-298/05 *Columbus Container Services* [2007] ECR I-10451.

⁶¹ Also known as the territoriality principle.

⁶² It shall be kept in mind that interpretation of the OECD MC should only be in line with domestic law when terms are not defined nor exhaustively defined in the Convention. See, E. Reimer and A. Rust, *Klaus Vogel on Double Taxation Conventions*, Vol. 1, (4th Edn., Kluwer Law 2015), para. 114, p. 208.

⁶³ Ben J.M. Terra and Peter J. Wattel, *European Tax Law*, (6th Edn., Kluwer Law 2012), p. 210-211.

⁶⁴ Ibid, p. 886-887.

⁶⁵ See for example, case C-264/96 *ICI* [1998] ECR I-4695, para. 28; Case C-168/01 *Bosal Holding BV* [2003] ECR I-9409, para. 42.

the Court has dealt with cases that regards juridical double taxation and how the basic principles of the Court are in this matter. This will be examined in subsequent Chapter (3.2).

3.2 Fundamental Freedoms and ECJ Case Law

Despite the lack of harmonization of direct taxation within EU, the Court has made several fundamental decisions in recent years where the focus is on the far-reaching effect of the TFEU fundamental freedoms regarding direct taxation. For this reason, the ECJ has developed a number of case laws on the compatibility of domestic tax rules with the TFEU⁶⁶ since Member States must exercise their competence consistently with EU law, even though direct taxation falls within their competence.⁶⁷

EU law provides no legal basis for choosing connecting factors for defining taxing jurisdiction. It is therefore made impossible on the basis of EU law whether the source State, the residence State or, in that sense, the nationality State has the preference to tax the income⁶⁸ of a person.⁶⁹ Primary EU law has therefore no position of choosing between the source State or the resident State, including the fact that it has no provision prohibiting intra-EU double taxation.

Pursuant to anti-hybrid rules, the taxation of instruments in one jurisdiction is connected to the tax outcome observed in another jurisdiction.⁷⁰ Theoretically, hybrid mismatch arrangements cannot occur in pure domestic situations since its main kernel is in cross-border situations. Due to the fact that international tax arbitrage requires a cross-border situation, the result of such rules is that tax advantages are granted in purely domestic situations which are denied in a cross-border situation.⁷¹ For this reason, question arises if anti-hybrid rule, as provided in Article 4.1(a) PSD, is contrary to the TFEU fundamental freedoms. An attempt will be made to answer this question in the following chapters.

3.2.1 Silence of EU Primary Law

Double taxation and double non-taxation are not prohibited in primary EU law but despite that fact, it has been questionable whether both these concepts could be considered an obstacle to the internal market by hindering the TFEU fundamental freedoms.

The ECJ usually finds a violation of EU law whenever a Member State imposes a tax disadvantage on non-resident taxpayers that is not endured by similarly situated domestic taxpayers.⁷² The disadvantage might entail the imposition of heavier tax treatment for non-residents than residents in comparable situations. Nevertheless, the problem of double taxation is difficult and by analysing double taxation under the fundamental freedoms, the

⁶⁶ G.W. Kofler and C.P. Schindler, “‘Dancing with Mr D’: The ECJ’s Denial of Most-Favoured-Nation Treatment in the ‘D’ case”, (2005) *European Taxation*, Vol. 54, No 12, p. 531.

⁶⁷ See for example, case C-80/94 *Wielockx* [1995] ECR I-2493, para. 16.

⁶⁸ Ben J.M. Terra and Peter J. Wattel, *European Tax Law*, (6th Edn., Kluwer Law 2012), p. 884.

⁶⁹ Individual or a legal person.

⁷⁰ J. Bundgaard, ‘*Hybrid Financial Instrument and Primary EU Law – Part 1*’, (2013) *European Taxation*, Vol. 53, No 11, p.539; cf. OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements*, *OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing, para. 66.

⁷¹ J. Bundgaard, ‘*Hybrid Financial Instruments and Primary EU Law – Part 2*’, (2013) *European Taxation*, Vol. 53, No 12, p. 587.

⁷² See case C-294/97 *Eurowings* [1999] ECR I-7447, para. 44.

disadvantage is created by the integration of laws of two taxing jurisdictions instead of just one.⁷³ The same applies for double non-taxation.

In 2009, Article 293 of the EC Treaty, which had the aim of abolishing double taxation within the Union, was revoked. Even though the provision was quite clear some doubts remained as to what extent Member States should give up their tax sovereignty to ensure that income was not subject to double taxation.⁷⁴ Therefore, the wording of TFEU does not indicate any guidance of avoiding double taxation within the EU. Member States are free to enact provisions based on their national sovereignty, a *positive integration*, but they have to be careful of legislations set through *negative integration*. These negative integrations have been exercised by the Court in order to guarantee that no discriminatory national law exists within Member States and ensuring the application of the TFEU freedoms.

3.2.2 Should Double Non-Taxation be under the Competence of EU?

Until the ECJ's judgement in the *Kerckhaert & Morres* case,⁷⁵ the Court had not represented any guidance regarding unrelieved double taxation. In that particularly case, the Court states it clearly that it is within the competence of a Member State to enact measures necessary to prevent juridical double taxation.⁷⁶ This conclusion indicates that in the case of Member State, exercising worldwide tax jurisdiction, the resident State must treat foreign source income of its residents consistently with the way it has divided its tax base and must not discriminate between foreign source and domestic income. This was also one of the Court's reasoning in the *Test Claimants* case⁷⁷ where it was upheld that resident State's legislation should not have the effect that foreign source income would be treated less favourably than domestic source income. The Court also concluded in *Manninen*,⁷⁸ *Verkooijen*⁷⁹ and *Lenz*⁸⁰ that in so far as the resident State chooses to relieve economic double taxation on inbound dividends, it must provide the same relief for incoming foreign sourced dividends and must therefore take foreign corporation tax paid into account for this purpose.⁸¹ As well, in *Gilly*,⁸² the Court observed that the free movement provisions provided in the Treaty do *not* oblige Member States to relieve double taxation, consequently because of the absence of any unifying or harmonizing measures adopted in the Union legislation.⁸³

The Court has been consistent in its judgements after *Kerckhaert & Morres*, for example in *Damseaux*⁸⁴ and *Block*.⁸⁵ In *Damseaux* the Court adds that despite the fact that both the

⁷³ Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I-11673, Opinion of AG Geelhoed, para. 48.

⁷⁴ K. Daxkobler and E. Huisman, 'Levy & Sebbag: The ECJ Has Once Again Been Asked to Deliver Its Opinion on juridical Double Taxation in the Internal Market', (2013) *European Taxation*, Vol. 53, No 8, p. 403.

⁷⁵ Case C-513/04 *Kerckhaert and Morres* [2006] ECR I-10967.

⁷⁶ *Ibid*, para. 23.

⁷⁷ Case C-446/04 *Test Claimants in the FII Group Litigation* [2006] ECR I-11753, para. 58.

⁷⁸ Case C-319/02 *Manninen* [2004] ECR I-7477.

⁷⁹ Case C-35/98 *Verkooijen* [2000] ECR I-4071.

⁸⁰ Case C-315/02 *Lenz* [2004] ECR I-7063.

⁸¹ However, the circumstances in the *Kerckhaert & Morres* case on the one hand and in the *Manninen*, *Verkooijen* and *Lenz* on the other are not comparable since the *Kerckhaert & Morres* is not about whether the Member State had chosen to relieve economic double taxation on domestic source dividend without granting similar relief to foreign source dividend.

⁸² Case C-336/96 *Gilly* [1998] ECR I-2793, para. 23.

⁸³ Case C-336/96 *Gilly* [1998] ECR I-2793, paras. 30 and 31; Case C-307/93 *Saint-Gobain* [1999] ECR I-6161, para. 57.

⁸⁴ Case C-128/08 *Damseaux* [2009] ECR I-6823, paras. 27, 30 and 33.

⁸⁵ Case C-67/08 *Block* [2009] ECR I-883, para. 30.

Member States are liable to tax the dividends, there are no obligations under EU law levied on the Member State of residence to avoid or prevent the disadvantages which could potentially arise from the competence attributed by the two Member States.⁸⁶ The same argument should therefore apply if the circumstances are reversed; there are no obligations under EU law to tax the income if the other State curbs from taxing it.

EU law does not lay down any general criteria for the attribution of areas of competence between Member States in relation to the elimination of double taxation within the Union.⁸⁷ It is also clear that the Treaty freedoms do not indicate any priority of assumption of taxing jurisdiction, nor do they require Member States to adapt their direct tax systems to satisfy or fit the direct tax system of other Member States in order to guarantee that companies should be taxed, at national level, in the same way as companies that choose to establish itself in another Member State.⁸⁸ This can be seen from the *Columbus Container*⁸⁹ case where the Court stated that Member States enjoy certain autonomy. Following that tax competence, companies are free to choose between different Member States. It can therefore be argued that the Court is, in a way, rejecting the correspondence principle as Member States are not obliged to take the deviating tax consequences in the other State into account. In a pending case of the Court, *Masco Denmark ApS*,⁹⁰ AG Kokott in her opinion approach the subject in the same manner as the Court did in *Columbus Container*,⁹¹ *Deutsche Shell*,⁹² *Amurta*⁹³ and *Block*.⁹⁴ It can therefore be reasonably argued that tax treatment in the former Member State should not affect taxation in the latter.

In addition, the freedoms do not provide any guarantee to taxpayers that changing jurisdictions will always be neutral from a tax point of view.⁹⁵ Hence, avoiding juridical double taxation or not, is not considered to be a problem within the Union so why should double non-taxation be considered an issue? Are taxpayers not free to exercise their freedoms within EU and its legal framework? By analogy, these are the separate sides of the same coin, double taxation and double non-taxation. How can double non-taxation be considered a hindrance if double taxation is not? On what grounds can a directive oblige Member States to correct double non-taxation?⁹⁶ Indeed, the problem could be addressed differently if the tax arrangements have the aim of avoiding tax but presuming tax avoidance without any explanations given by the taxpayer cannot be upheld.⁹⁷ The objective of minimising one's tax burden has been considered by the Court to be a valid commercial consideration as long as the arrangements did not include amount to artificial transfer of profits. In *Eurowings* the Court stated clearly that if taxpayers have *not* entered into abusive practices, Member States should not hinder their exercise of the freedoms simply because the other Member States has lower

⁸⁶ Case C-128/08 *Damseaux* [2009] ECR I-6823, para. 34.

⁸⁷ Case C-128/08 *Damseaux* [2009] ECR I-6823, para. 33; Case C-513/04 *Kerckhaert & Morres* [2006] ECR I-10967, para. 22; Case C-298/05 *Columbus Container Services* [2007] ECR I-10451, para. 45.

⁸⁸ *Ibid.*

⁸⁹ Case C-298/05 *Columbus Container Services* [2007] ECR I-10451, para. 51.

⁹⁰ Opinion of AG Kokott in C-593/14 *Masco Denmark ApS*, 12th of May 2016, paras. 19 and 20.

⁹¹ Case C-298/05 *Columbus Container Services* [2007] ECR I-10451, para. 51.

⁹² Case C-293/06 *Deutsche Shell* [2008] ECR I-1129, para. 43.

⁹³ Case C-379/05 *Amurta* [2007] ECR I-9569, para. 78.

⁹⁴ Case C-67/08 *Block* [2009] ECR I-883, para. 31.

⁹⁵ This can be seen for example in case C-403/03 *Schempp* [2005] ECR I-6421, para. 46.

⁹⁶ C. Brokelind, 'Legal Issues in Respect of the Changes to the Parent-Subsidiary Directive as a Follow-Up of the BEPS Project', (2015) *Intertax*, Vol. 43, Issue 12, p. 822.

⁹⁷ Case C-28/95 *Leur-Bloem* [1997] ECR-4161, para. 44.

level of taxation,⁹⁸ but how can it be concluded if the practice is abusive or not? It can with a subjective measure.

The Court has stated that adverse effect of simultaneous source taxation and residence taxation of the *same item of income* is not caused by one of the two jurisdictions involved and for that reason it cannot be upheld that this is discrimination. A recent judgement⁹⁹ of the Court confirms this as well, the resident State is not obliged to prevent double taxation resulting from the parallel exercise of taxing rights by two Member States. The Court accepts that there is a certain tax obstacle to free movement within EU Member States resulting from the differences in the assertion of taxing power by two States and for that reason this obstacle stands outside the scope of the Treaty freedoms and cannot protect taxpayers despite the mere “*quasi-restriction*” to the freedoms. This however raises question why Member States should be protected of double non-taxation while taxpayers are not protected of juridical double taxation.

The obstacle of juridical double taxation is not a consequence of any discrimination by one of the two Member States involved. The Court does not differ if Member States in their domestic law address the taxing right to residence taxation (*worldwide income taxation*), source taxation (*territoriality taxation*) nor even nationality taxation. This can be seen from various examples of case law, such as in *Lidl Belgium*,¹⁰⁰ *SGI*¹⁰¹ and from the *Van Hilten*¹⁰² case. Taking all together, it is confirmed that the Court considers that the allocation of taxation power should be within the competence of Member States and that EU law has no authorization or legal basis to choose which country should have the right to tax nor avoid double taxation and hence, avoid double non-taxation. At first, it can therefore be presumed that the principle of single taxation is not an important factor in the EU legal framework since the above discussion indicates that EU law do not care about double taxation, so why should they care about double non-taxation? This demonstrates that the single tax principle is not considered to be a part within the EU even though the Union is putting effort in combatting and hindering double non-taxation. It can therefore be argued that the EU does not expect that income should be taxed once, and only once.

Notwithstanding, EU law is a part of the international tax regime and therefore it is necessary to examine whether tax treaty law give any further answers about the single tax principle. In this respect, it is fundamental to consider whether the avoidance of double non-taxation is one of the purposes of the OECD MC and hence, if tax treaty law presume single taxation. The general expectation amongst Contracting States is that an item of income should be taxed in at least one State.¹⁰³ It may reasonably be argued that when States enter into tax treaty agreements they have a common expectation that double non-taxation will be prevented¹⁰⁴ and such aspect supports the principle of single taxation. The OECD Partnership Report from

⁹⁸ Case C-294/94 *Eurowings* [1999] ECR I-7447, para. 44.

⁹⁹ Case C-194/15 *Baudinet and Others* [not yet published].

¹⁰⁰ Case C-414/06 *Lidl Belgium* [2008] ECR I-3601, para. 33.

¹⁰¹ Case C-311/08 *SGI* [2010] ECR I-487, para. 60.

¹⁰² Case C-513/03 *Van Hilten* [2006] ECR I-1957, para. 45.

¹⁰³ Van Weeghel, S., *Improper Use of Tax Treaties*, (Kluwer Law 1998), p. 33 and 105; cf. E. Reimer and A. Rust, *Klaus Vogel on Double Taxation Conventions*, Vol. 1, (4th Edn., Kluwer Law 2015), para. 130, p. 59.

¹⁰⁴ L. De Broe, *International Tax Planning and Prevention of Abuse*, (IBFD 2008), p. 357.

1999¹⁰⁵ indicates that avoiding double non-taxation is the reverse of the treaty's primary purpose, namely, avoiding double taxation. Including the addition of Article 23 A(4) to the OECD MC in 2000 and the revision in 2003 where the OECD Committee amended a part of Article 1 of the Commentary aiming at preventing double non-taxation¹⁰⁶ by restricting the entitlement to treaty benefits.¹⁰⁷ Hence, the underlying aim of the Convention is also to prevent double non-taxation by not allowing treaty benefits if resulting in double non-taxation. It can therefore be argued that States presume single taxation of income and capital when negotiating in double tax treaty.

Although it is not within the competence of Union law to examine the relationship between a national measure of a Member States and DTC,¹⁰⁸ there might however be a way to cure double non-taxation with a multilateral EU tax treaty and hence follow the principle of single taxation. The *Nordic Convention* could be a model for this multilateral treaty.¹⁰⁹ The Nordic Convention includes a special article which has the purpose of avoiding double non-taxation situation caused by national laws.¹¹⁰ In accordance to Article 26(2), if the treaty attributes the taxing right of any income to a State other than the residence State, and the other State, based on its national law, does not subject such income to tax liability in its entirety, the income shall be taxable in the residence State to the extent it is not included in the tax liability in the other State. That said, the Nordic Convention could work as a model for a multilateral EU treaty, but provisions addressing double non-taxation situations should be strengthened in conformity with EU law.¹¹¹

Despite all, the fundamental question of whether an arrangement leading to double non-taxation abuses EU law still remain unanswered.¹¹² On the other hand, if there is no obligation in accordance with EU law to prevent double taxation it is inconsistent to accept the avoidance of double non-taxation as a basis to justify restrictions.¹¹³ As well, after scrutinizing the international tax regime (3.2), where single taxation plays an important role, it can be reasonably argued that EU should take the principle into considerations since the Union is a part of the international tax regime, following that it should both care about double

¹⁰⁵ OECD, *The Application of the OECD Model Tax Convention to Partnerships, Issues in International Taxation*, No. 6 (1999) Paris, para. 52, p. 20.

¹⁰⁶ Adolfo J. Martín Jiménez, 'The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A case for the Declining Effect of the OECD Commentaries?' (2004) *Bulletin of International Taxation*, Vol. 58, No 1, p. 22.

¹⁰⁷ OECD. (2003), *2002 Reports Related to the OECD Model Tax Convention*, Issues in International Taxation, No. 8, OECD Publishing, p. 13.

¹⁰⁸ Case C-298/05 *Columbus Container Services* [2007] ECR I-10451, paras. 44-47.

¹⁰⁹ M. Helminen, 'The Problem of Double Non-Taxation in the European Union – To What Extent Could This Be Resolved through a Multilateral EU Tax Treaty Based on the Nordic Convention?', (2013) *European Taxation*, Vol. 58, No 7, p. 308.

¹¹⁰ Article 26(2) of the Nordic Convention, cf. M. Helminen, 'The Problem of Double Non-Taxation in the European Union – To What Extent Could This Be Resolved through a Multilateral EU Tax Treaty Based on the Nordic Convention?', (2013) *European Taxation*, Vol. 58, No 7, p. 309.

¹¹¹ *Ibid*, p. 312.

¹¹² L. De Broe, 'Some observation on the 2007 communication from the Commission: "The application of anti-abuse measures in the area of direct taxation within the EU and in relation to third countries"' (2008) 17 *EC Tax Review* 3, p. 142; J. Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 2', (2013) *European Taxation*, Vol. 53, No 12, p. 593; Christoph Marchgraber, 'Tackling Deduction and Non-Inclusion Schemes – The Proposal of the European Commission', (2014) *European Taxation*, Vol. 54, No 4, p. 140-141.

¹¹³ J. Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 2', (2013) *European Taxation*, Vol. 53, No 12, p. 593; cf. Christoph Marchgraber, 'Tackling Deduction and Non-Inclusion Schemes – The Proposal of the European Commission', (2014) *European Taxation*, Vol. 54, No 4, p. 140.

taxation *and* double non-taxation. Such is however not in accordance to the law as it stands today.

3.2.3 Identifying a Restriction and/or Discrimination

All measures that prohibit, impede or render less attractive the exercise of the basic freedoms can be regarded as restrictions¹¹⁴ (*traditional restriction text*).¹¹⁵ At first glance, it can therefore be expected that there is an obstacle to the freedoms if an anti-hybrid rule is the deciding factor for companies, which are resident in Member States that has enacted an anti-hybrid rule based on Article 4.1(a) PSD, *not* to establish another company in a Member State that allows interest deduction. Such anti-hybrid rule would definitely render less attractive the exercise of the freedoms. On the other hand, this is not that simple and needs therefore further examination.

In accordance to established principles of ECJ case law the analysis of national tax rules of Member States are carried out in three steps. In the beginning the scope is determined by *identifying the applicable freedom*.¹¹⁶ The relevant freedoms provided in TFEU regarding hybrid mismatch instruments are the freedom of establishment (*Article 49 and 54 TFEU*) and the free movement of capital (*Article 63 TFEU*). Not surprisingly, the concept of hybrid financial instrument is not mentioned in the TFEU but may however be protected under the two mentioned freedoms. Since those provisions are primary rules compared to the general prohibition of discrimination in Article 18 TFEU, the general prohibition provision does not come into question if the freedom provisions are relevant in the case¹¹⁷ as they are on the superior level.¹¹⁸ In general, it can be stated that the fundamental freedoms covers all forms of cross-border economic activities and investment including prohibiting tax provisions, intertwined with the equality principle, that have the ability to create discriminatory obstacles to cross-border arrangements.¹¹⁹

The *second step* in the analysis is identifying a possible restriction and/or discrimination. The understanding of a restriction has been considered to be broader than discrimination since it covers more obstacles to the function of the internal market. Taxation that restricts the use of the basic freedoms may be in conflict with EU law, even where the treatment would not constitute discrimination.¹²⁰ Thus, it has not been clear in the Court's judgements so far whether the national tax legislation at issue results in different treatment of comparable situations or a restriction impediment to the freedom of establishment or the free movement of capital.¹²¹ In any event, the existence of a restriction and/or discrimination depends on

¹¹⁴ M. Helminen, *Chapter 2: Non-Discrimination and Basic Freedoms in EU Tax Law – Direct Taxation – 2015: 2015 Edn.* (IBFD 2015).

¹¹⁵ See for example, case C-55/94 *Gebhard* [1995] ECR I-4165, para. 37; Case C-157/07 *Krankenheim* [2008] ECR I-8061, para. 30.

¹¹⁶ J. Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part I', (2013) *European Taxation*, Vol. 53, No 11, p. 540.

¹¹⁷ *Ibid.*

¹¹⁸ For instance in C-311/97 *Royal Bank of Scotland* [1999] ECR-2651, para. 20.

¹¹⁹ Georg W. Kofler & Clemens P. Schindler, "'Dancing With Mr D": The ECJ's Denial of Most-Favoured-Nation Treatment in the "D" Case', (2005) *European Taxation*, Vol. 45, No 12, p. 531.

¹²⁰ See for example case C-118/96 *Safir* [1998] ECR I-1897, paras. 33-34.

¹²¹ Ben J.M. Terra and Peter J. Wattel, *European Tax Law*, (6th Edn., Kluwer Law 2012), p. 41, cf. J. Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part I', (2013) *European Taxation*, Vol. 53, No 11, p. 549.

whether the tax position of the whole group (the parent and the subsidiary/subsidiaries) should be taken into account or only on a standalone basis.¹²²

If the *discrimination approach* is upheld by the Court, the comparability analyse has to be a part of the discrimination test. Tax treatment of similarly situated intra-Union taxpayers must not entail any discrimination that would otherwise baffle their access to the fundamental freedoms. Based on these non-discrimination principles, ECJ has consistently held that unfavourable treatment of residents and non-residents taxpayers, which are considered to be in objectively comparable situations, is a breach of EU law unless the treatment can be held justified by the rule of reason. Hence, it must be determined whether residents and non-residents taxpayers are in objectively comparable situations. This factor is a crucial element for examining if there has been a breach of EU law and the *comparability test* is therefore strikingly important.¹²³

It is thus quite challenging for the ECJ to determine if the anti-hybrid rule, as provided in the PSD, is discriminatory under the EU discrimination framework; this includes the challenge of how the comparability analysis should be performed since hybrid mismatch arrangements are not likely to be found in purely domestic situations.¹²⁴ The difficulty lies in finding the comparator and if found, then questions arise if deviating tax consequences in another jurisdiction should be important when identifying the correct comparator.¹²⁵

Despite the challenge of this subject, the ECJ has provided minor guidance of criteria used to determine if the situations in question are comparable. The concept of “*objectively comparable situations*” remains therefore quite open and ambiguous. More disturbingly, the Court’s judgements are not always consistent with one another,¹²⁶ which results in a complex and confusing legal environment, concluding if situations are comparable or not. The Court, however, generally adopts two main approaches with regards to its comparability analysis. These are the “*overall approach*”¹²⁷ and the “*per-country approach*.”¹²⁸ The former one target the overall tax situations of a taxpayer, or a group of taxpayers, and for this reason the ECJ examines the tax treatment in more than a single Member State, contrary to the latter where the circumstances are examined on a standalone basis.¹²⁹ The cross-border situations under the overall approach are assessed in isolation without taking into account of comparable situations. In such analysis the Court takes into consideration the *deviating tax consequences* in the other Member State where the analysis focuses on the overall tax burden which may arise from different jurisdictions compared to similar situations.¹³⁰ The Court established this

¹²² Ibid, p. 550.

¹²³ J. Bundgaard, ‘Hybrid Financial Instruments and Primary EU Law – Part 1’, (2013) European Taxation, Vol. 53, No 11, p. 549.

¹²⁴ Kasper Dziurdz and Christoph Marchgraber, *Non-Discrimination in European and Tax Treaty Law*, (Linde Publications 2015), p. 64-65.

¹²⁵ Ibid.

¹²⁶ J. Englisch, ‘Taxation of Cross-Border Dividends and EC Fundamental Freedoms’, (2010) Intertax, Vol. 33, Issue 8/9, p. 197.

¹²⁷ Also known as the internal market approach.

¹²⁸ Also known under the subject-to-tax approach.

¹²⁹ J. Bundgaard, ‘Hybrid Financial Instruments and Primary EU Law – Part 1’, (2013) European Taxation, Vol. 53, No 11, p. 550; Dennis Weber, ‘In Search of a (New) Equilibrium between Tax Sovereignty and the Freedom of Movement Within the EC’ (2006) Intertax, Vol. 34, Issue 12, p. 599.

¹³⁰ Kasper Dziurdz and Christoph Marchgraber, *Non-Discrimination in European and Tax Treaty Law*, (Linde Publications 2015), p. 76.

approach in *Schumacker*¹³¹ and it has been applied later on for several subsequent cases.¹³² The Court has looked for a solution with the overall approach whereby in EU cross-border situations particular items¹³³ should at least taken into account once.¹³⁴

The *per-country approach* can be seen in various case law, for instance in *Eurowings* where the Court did not take into account the deviating tax consequences in the other Member State when concluding that non-residents were in less favourable situations than German resident companies.¹³⁵ The Court examines the disadvantage created by the German trade tax legislation in isolation and without taking into account the potential tax burden of the lessor in another Member States. The EFTA Court also applied for this approach in its decision in *Fokus Bank*.¹³⁶ The issue at stake was that residents which received domestic dividends paid in Norway were not taxed while non-residents receiving dividends cross-borders had to pay withholding tax. The Court examined solely the Norwegian legislation and concluded that Norway could not shifts its obligations to comply with the EEA Agreement to another State by relying on the latter to make good for discrimination and disadvantaged caused by the Norwegian legislation.¹³⁷ As well, the ECJ rejected the idea of viewing the group as a whole, and hence the overall approach, in *SGI*.¹³⁸ The Governments in question based their observations on a global view of the group of companies and presumed that it was irrelevant to which company within a group particular income is attributed. The Court disagreed and stated that the resident company and the recipient company where separate legal persons, both having their own individual tax liability.¹³⁹ Similarly in *Lenz*,¹⁴⁰ by comparing residents who received dividends from Austrian companies to residents who received dividends from companies in another Member State, the Court used the per-country approach. It considered that shareholders who received dividends from companies established in another Member State were comparable to shareholders who received dividends from Austrian companies. Factors related to non-Austrian companies, which paid dividends to Austrian residents, were not relevant in the comparability analysis.¹⁴¹ Furthermore in *Keller Holding*,¹⁴² the Court said it irrelevant for the purpose of the comparability analysis that foreign indirect subsidiaries were not subject to corporate tax in Germany.

It can therefore be argued, in conformity with the standalone company, that it would be more straightforward that domestic legislation, which disallows a participation exemption, leaves the parent company in a worse tax situation than a company that receives a non-deductible dividends from a domestic subsidiary or, in that sense, from a subsidiary situated in another

¹³¹ Case C-279/93 *Schumacker* [1995] ECR I-225.

¹³² Case C-80/94 *Wielockx* [1995] ECR I-2493; Case C-107/94 *Asscher* [1996] ECR I-3089; Case C-168/01 *Bosal Holding BV* [2003] ECR I-9409; Case C-152/03 *Ritter-Coulais* [2006] ECR I-1711; Case C-446/03 *Marks & Spencer* [2005] ECR I-10837; Case C-182/06 *Lakebrink* [2007] ECR I-6705.

¹³³ For example, losses/source-based and deductions/personal allowances as can be seen from cases like *Marks & Spencer* and *Schumacker*.

¹³⁴ Dennis Weber, 'In Search of a (New) Equilibrium between Tax Sovereignty and the Freedom of Movement Within the EC' (2006) *Intertax*, Vol. 34, Issue 12, p. 599.

¹³⁵ Case C-294/97 *Eurowings* [1999] ECR I-7447, paras. 40, 42 and 44.

¹³⁶ EFTA, 23 November 2004, *Fokus Bank ASA* [2004] 2006/C 45/06.

¹³⁷ *Ibid*, paras. 34, 43 and 44.

¹³⁸ Case C-311/08 *SGI* [2010] ECR I-487.

¹³⁹ *Ibid*, paras. 51-52.

¹⁴⁰ Case C-315/02 *Lenz* [2004] ECR I-7063.

¹⁴¹ *Ibid*, para. 42.

¹⁴² Case C-471/04 *Keller Holding* [2006] ECR I-2107, para. 38.

Member State.¹⁴³ With the overall approach the company group does not seem to be in a worse situation where dividends are received from a subsidiary in a Member State that allows tax deduction for the dividends in the form of interest expenses compared to dividends that is received from either a domestic or foreign subsidiary residing in another Member State where a deduction is not accepted.¹⁴⁴ By using two methods that come to separate conclusions, it would be inconsistent against the nature of law and the protection of taxpayers if the Court would analyse hybrid mismatch arrangements under the overall approach and hence disregard a method which leads such arrangements to be discriminated..

On the other hand, the per-country approach¹⁴⁵ is critical and has been rejected by AG Geelhoed in his opinions in *ACT Class IV*, *Kerckhaert-Morres* and *Denkavit*. In his opinions he expresses that the taxation in the other Member States *has* to be taken into consideration in order to decide whether a restriction of the fundamental freedoms exists. He states that examination of the situation of an individual economic operator in the framework of just one Member State may give an unbalanced and misleading impression and hence fail to capture the economic reality “*in which that operator is acting.*”¹⁴⁶ Apparently, P.J. Wattel seems to join AG Geelhoed’s view in this matter.¹⁴⁷ However, both J. Bundgaard and D. Weber are of different opinion and support the per-country approach as they consider it more in line with the EU landscape.¹⁴⁸ Their arguments are quite convincing as tax advantages and tax disadvantages are the consequences of disparities between jurisdictions. The Court has repeatedly stated in its judgements that disparities are outside the scope of the prohibitions of the TFEU freedoms and that these distorting disparities are accepted as a result of fiscal sovereignty of any Member State.¹⁴⁹ They are not covered by the fundamental freedoms as long as there is no unilateral obstacle of cross-border transactions.¹⁵⁰ As can be seen from various case law,¹⁵¹ for example in *Gilly, N, Kerckhaert & Morres, Test Claimants in the Thin Cap Group Litigation* and *Oy AA*, the allocation of taxing rights of Member State is in accordance with EU law. This is also the result where the tax treatment in one of the State would be more burdensome than in the other.¹⁵² As seen in *Deutsche Shell*¹⁵³ and

¹⁴³ J. Bundgaard, ‘Hybrid Financial Instruments and Primary EU Law – Part I’, (2013) European Taxation, Vol. 53, No 11, p. 550; Dennis Weber, ‘In Search of a (New) Equilibrium between Tax Sovereignty and the Freedom of Movement Within the EC’ (2006) Intertax, Vol. 34, Issue 12, p. 551.

¹⁴⁴ Ibid.

¹⁴⁵ At least like represented in the *Fokus Bank* case.

¹⁴⁶ AG Geelhoed opinion in C-524/04 *Test Claimants in the Thin Gap Group Litigation* [2007] ECR I-2107, para. 72.

¹⁴⁷ Opinion of AG Wattel of 31 of January 2006, No. 39.819, point. 8.20; Opinion of Advocate General Wattel of 10 May 2006, No. 42.679, point 9.4.; P.J. Wattel, ‘EeAnjurisdictionele of overall-toepassing van EG-verboden op bronheffingen’, WFR 2006/6680, p. 847, cf. Dennis Weber, ‘In Search of a (New) Equilibrium between Tax Sovereignty and the Freedom of Movement Within the EC’ (2006) Intertax, Vol. 34, Issue 12, p. 601.

¹⁴⁸ Dennis Weber, ‘In Search of a (New) Equilibrium between Tax Sovereignty and the Freedom of Movement Within the EC’ (2006) Intertax, Vol. 34, Issue 12, p. 615.

¹⁴⁹ See Joined Cases C-283/94, C-291/94 and C-292/94 *Denkavit* [1996] ECR I-5063; Case C-513/04 *Kerckhaert and Morres* [2006] ECR I-10967; Case C-96/08 *CIBA* [2010] ECR I-2911.

¹⁵⁰ M. Helminen, *Chapter 2: Non-Discrimination and Basic Freedoms in EU Tax Law – Direct Taxation – 2015: 2015 edition* (IBFD 2015); S. Douma, ‘The Three Ds of Direct Jurisdiction: Disparity, Discrimination and Double Taxation’, (2006) European Taxation, Vol. 46, No 11, p. 524.

¹⁵¹ Case C-336/96 *Gilly* [1998] ECR I-2793, paras. 24 and 30; Case C-470/04 *N* [2006] ECR I-7409, para. 44; Case C-513/04 *Kerckhaert and Morres* [2006] ECR I-10967, paras. 22-23; Case C-524/04 *Test Claimants in the Thin Gap Group Litigation* [2007] ECR I-2107, para. 49; Case C-231/05 *Oy AA* [2007] ECR I-6373, para. 52.

¹⁵² M. Helminen, *Chapter 2: Non-Discrimination and Basic Freedoms in EU Tax Law – Direct Taxation – 2015: 2015 edition* (IBFD 2015).

Krankenheim,¹⁵⁴ Member States are not obliged to design its tax rules on the basis of those of another Member States in order to certify that the taxation removes disparities from national tax rules¹⁵⁵ so why should deviating tax consequences in another Member State be taken into account? By accepting disparities, the ECJ is indirectly acknowledging the per-country approach and it can be argued that the Court would be going against its own judgements by denying this particular approach. The tax advantages and disadvantages do not arise because of the existence of one tax system. They arise because of 28 independent tax systems that operate at the same time, having their own rules which are not (always) harmonized¹⁵⁶ and hence should situations regarding hybrid financial arrangements be examined on a standalone basis with a view of a tax regime of only one Member State.

3.2.4 Final Remarks

The underlying questions in *Chapter 3.2*, and its sub-chapters, were of three kinds: first, whether double non-taxation violates EU law, second, is single taxation a part of the EU legal environment and last, whether a measure that is enacted by Member States based on Article 4.1(a) of the PSD is violating EU law or not.

Regarding the first two questions, it was argued that it would be inconsistent if double non-taxation could justify a restriction since no obligations lie on Member States in accordance to EU law to prevent double taxation. Additionally, as the international tax regime relies on the principle of single taxation, the principle should also be approved and a part of the EU environment. On the other hand, double taxation and double non-taxation are not forbidden in EU primary law so it remains doubtful that the Union can apply single taxation. As an unwritten international tax principle it should have more weight in within the EU and in accordance to the aim of this thesis, examination will be made how single taxation can be secured under EU law. Such an examination is combined with the discussion in following chapters (3.3 and 3.4) and gets its own heading in *Chapter 4*.

Regarding the last question, it is necessary to remember that Member States are free to decide their own tax policies on the field of direct taxation and such results in a diverse set of tax systems coexists where 28 discrete sovereign tax systems exist simultaneously.¹⁵⁷ Variations and disparities between jurisdictions are thus to be anticipated.¹⁵⁸ For this reason, Member States cannot be required to take deviating tax consequences of other Member States into account and opening that possibility to the recognition of deviating tax consequences at the comparability level is not suitable for a non-harmonized tax environment.¹⁵⁹ This would wrongfully assume that tax legislation of Member States is comparable.¹⁶⁰

¹⁵³ Case C-293/06 *Deutsche Shell* [2008] ECR I-1129, para. 43.

¹⁵⁴ Case C-157/07 *Krankenheim* [2008] ECR I-8061 para. 50.

¹⁵⁵ M. Helminen, *Chapter 2: Non-Discrimination and Basic Freedoms in EU Tax Law – Direct Taxation – 2015: 2015 edition* (IBFD 2015).

¹⁵⁶ Dennis Weber, 'In Search of a (New) Equilibrium between Tax Sovereignty and the Freedom of Movement Within the EC' (2006) *Intertax*, Vol. 34, Issue 12, p. 614.

¹⁵⁷ See Case C-307/07 *Saint-Gobain* [1999] ECR I-6161, para. 56; Case C-336/96 *Gilly* [1998] ECR I-2793, paras. 24-30.

¹⁵⁸ Di Maria, 'Comparability in the case of Hybrid Mismatch', in *Non-Discrimination in European and Tax Treaty Law*, edited by Kasper Dziurdz and Christoph Marchgraber, (Linde Publication 2015), p. 84.

¹⁵⁹ M. Lang, 'Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions and Contradictions', (2009) *EC Tax Review*, Vol. 18, Issue 3, p. 110.

¹⁶⁰ Di Maria, 'Comparability in the case of Hybrid Mismatch', in *Non-Discrimination in European and Tax Treaty Law*, edited by Kasper Dziurdz and Christoph Marchgraber, (Linde Publication 2015), p. 84.

If there is potential tax discrimination between taxpayers, the analysis should rather be dealt with under the method which is more likely to conclude such and that is *the per-country approach* at the comparability level. By examining the situations under that approach, the Court is indeed more likely to conclude that a national measure, based on the PSD anti-hybrid rule, is discriminatory and thus violating the TFEU fundamental freedoms. Taxpayers are therefore more likely to be discriminated based on the comparability analysis if domestic participation regime does not apply in the context of cross-border hybrid financial arrangements. This leads however to another question; whether the discrimination and/or restriction can be justified (3.3).

3.3 Justification Grounds

Under the three step analysis established by the ECJ (3.2.3) the final and third step is to examine whether a national measure can be held justifiable or not. The analysis is known as the doctrine of justification (*rule of reason*) for measures that may hinder the TFEU freedoms but nonetheless justify direct or indirect discrimination, particularly in tax matters. These justifications grounds are unwritten and were first introduced in the *Cassis de Dijon*¹⁶¹ case.

Different types of justification grounds have been accepted while others have been rejected by the Court but it is settled case law that a restriction of the freedoms can only be held justified if the debateable measure pursues a legitimate aim compatible with the Treaty, justified by the rules of reason¹⁶² and does not go beyond necessary. In the following discussion only relevant justifications grounds that could potentially justify a rule based on the PSD anti-hybrid rule will be examined. The justification grounds discussed in the following sub-chapters are chosen after relevancy to the discriminated and/or restricted measure at issue. It shall be kept in mind that loss of States revenue is not one of the justifications worth safeguarding and has never been acknowledged by the Court as a reason for restricting the right of establishment or the free movement of capital since it does not constitute an overriding reason in the public interest.¹⁶³

3.3.1 Preventing Tax Avoidance

When the Court started to apply the fundamental freedoms in the area of tax, it did not take Member States a long time trying to justify restrictive and/or discriminatory measures on the ground of countering tax evasion and avoidance including the necessity to exercise fiscal supervision.¹⁶⁴ Member States may argue that they are indeed neutralizing the taxation of cross-border hybrid financial instruments within MNE's by hindering certain tax avoidance which involves transfer of profit from a high tax jurisdiction to a low tax. The Court has however repeatedly stated in its case law that any advantage resulting from the low taxation to which a subsidiary is established in another Member State than the parent is resident, cannot by itself authorize that State to offset that advantage by less favourable tax treatment of the parent company.¹⁶⁵ By analogy, this reasoning of the Court should also apply for tax

¹⁶¹ Case 120/78 *Cassis di Dijon* [1979] ECR 649, para. 8.

¹⁶² See for example in Case C-360/06 *Heinrich Bauer Verlag* [2008] ECR I-7333, para. 34; cf. Sjoerd Douma, *Optimization of Tax Sovereignty and Free Movement*, (2011), p. 33.

¹⁶³ See Case C-264/96 *ICI* [1998] ECR I-4695, para. 28; Case C-307/97 *Saint-Gobain* [1999] ECR I-6161, para. 51; Case C-35/98 *Verkooijen* [2000] ECR I-4071, para. 48.

¹⁶⁴ Frans Vanistendael, 'Is Tax Avoidance the Same Thing under the OECD Base Erosion and Profit Shifting Action Plan, National Tax Law and EU Law?' (2016) *Bulletin for International Taxation*, Vol. 70, No. 3, p. 166.

¹⁶⁵ Case 270/83 *Avoir Fiscal* [1986] ECR 273, para. 21; Case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995, para. 49.

advantage resulting for subsidiaries in the Member State in which they are established and therefore the Member State of the parent cannot justify less favourable treatment in tax matters given to the parent company.¹⁶⁶ The Court has clarified that using the internal market in order to profit from special tax regime is not considered an abuse of law and cannot therefore be used by another Member State to justify less favourable treatment for the parent company.¹⁶⁷ It is also apparent from case law that the mere fact that a resident company in one Member State establish a company in another Member State cannot set up a general presumption of tax avoidance and justify a measure which compromises the exercise of the fundamental freedoms provided in the TFEU.¹⁶⁸ As well, in *Halifax*¹⁶⁹ the Court stated that “for it to be found that an abusive practice exists, it is necessary [...] that the transactions concerned [...] result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions.”¹⁷⁰ Additionally, the Court said it must also be apparent from a number of objective factors that “the essential of the transactions concerned is to obtain a tax advantage.”¹⁷¹ Accordingly, for an anti-hybrid rule to be justified for the Court, the hybrid mismatch arrangements must have the purpose to obtain a tax advantage. The ECJ did take this abusive doctrine, established in *Halifax*, even further in *Cadbury Schweppes* where it concluded that a national measure restricting the freedom of establishment may be held justified where it specially relates to *wholly artificial arrangements* which have the aim of circumventing the application of the Member States concerned.¹⁷² This indicates that a measure can only be justified if wholly artificial. The Court narrows its *Halifax* conditions in *Cadbury Schweppes* whereas taxpayers needs to have the *sole aim* of obtaining tax advantages by establishing wholly artificial arrangements to achieve that aim.

Classification of transaction as wholly artificial has been considered to depend on two elements: the subjective intension to achieve a tax advantage (*subjective element*) and the failure to comply with the purpose of the fundamental freedoms under discussion (*objective element*).¹⁷³ In its case law,¹⁷⁴ the Court has concluded that a general presumption of tax avoidance is not sufficient to justify a tax measure that violates the fundamental freedoms. The Court seems not willing to accept justification based on the fact that certain types of financial arrangements can be abusive in and of itself.¹⁷⁵ Therefore, hybrid financial instruments in cross-border context cannot per se be considered illegal or wholly artificial.¹⁷⁶

On the other hand, it can be argued that anti-hybrid rules target *only* artificial arrangements with the aim of exploiting mismatches in the classification of financial instruments in

¹⁶⁶ Case C-295/97 *Eurowings* [1999] ECR I-7447, para. 44.

¹⁶⁷ *Ibid.*

¹⁶⁸ Case C-264/96 *ICI* [1998] ECR I-4695, para. 26; Case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995, para. 50. Even though tax evasion and tax avoidance is not the same thing, it may be assumed that the Court means here tax avoidance despite the fact of referring to tax evasion and simply is confusing concepts.

¹⁶⁹ Case C-255/02 *Halifax and others* [2006] ECR I-1609, para. 86.

¹⁷⁰ *Ibid.*

¹⁷¹ *Ibid.*

¹⁷² Case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995, para. 51.

¹⁷³ M. Hilling, ‘Justifications and Proportionality: An Analysis of the ECJ’s Assessment of National Rules for the Prevention of Tax Avoidance’, (2013) *Intertax*, Vol. 41, Issue 5, p. 297.

¹⁷⁴ Case C-72/09 *Rimbaud* [2010] ECR I-10659, para. 34.

¹⁷⁵ Case C-264/96 *ICI* [1998] ECR I-4695, para. 26; Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779, para. 37.

¹⁷⁶ J. Bundgaard, ‘Hybrid Financial Instruments and Primary EU Law – Part 2’, (2013) *European Taxation*, Vol. 53, No 12, p. 593.

different Member States in order to obtain double non-taxation.¹⁷⁷ This thesis highlights how this is not a convincing argument since the Court has repeatedly stated that mismatches in tax treatments does not constitute an abusive practice if the hybrid financial instrument stems from a real economic activity between related companies and if the terms of the loans are within arm's length including satisfying the financial need of the subsidiary by a loan.¹⁷⁸ What supports this argument is that after the PSD amendments in 2014 the hybrid financial instruments are not re-characterized for tax purposes since only the tax treatment of the amount received of the parent is adjusted by taking into account the deviation of the tax consequences in the subsidiary State. It should also be kept in mind that taxpayers may do financial arrangements with hybrid elements for a variety of non-tax reasons.¹⁷⁹ It has been cleared by the Court that taxpayers must always have the possibility to prove that there are some business reasons for an arrangements. Therefore, anti-tax avoidance measure, that automatically applies to certain arrangements like hybrid financial instruments, without any saying of the taxpayers, cannot under normal circumstances be considered to be in line with EU law.¹⁸⁰

Apparently, in *Marks & Spencer* the Court made however a reference to the risk of tax avoidance if losses originated in the subsidiary would not be taken into account.¹⁸¹ The circumstances in that case were not wholly artificial so hypothetically the Court is open for the possibility that tax treatment in a situation not involving wholly artificial arrangements can be justified but in accordance to now established case law it could never been accepted as a standalone justification.

Arguments indicate quite decisively that the anti-hybrid rule of Article 4.1(a) PSD is not in line with the Court's case law since no subjective measure is applicable to decide if the taxpayers arrangements are artificial, wholly or even partly, or not. As well, under the provision it is not secured that the taxpayer can prove that the arrangements are genuine and reflect in economic reality. Therefore, the need for the rule to reconcile with the Court's case law, a subjective measure is a necessary element for the anti-hybrid rule to be considered legitimate under the TFEU freedoms. Including, it is highly important that the rule will not automatically apply without any saying of the taxpayer. It is therefore likely that the Court would not accept this justification ground if it is going to be consistent with its earlier case law.¹⁸²

¹⁷⁷ Ramon Tomazela Santos, 'Prevention of Hybrid Mismatches as a Justification?', in *Non-Discrimination in European and Tax Treaty Law*, edited by Kasper Dziurdz and Christoph Marchgraper (Linde Publications 2015), p. 179.

¹⁷⁸ L. de Broe, 'Some observations on the 2007 communication from the Commission: The application of anti-abuse measures in the area of direct taxation within the EU and in relation to third countries', (2008) 17 EC Tax Review 3, p. 146.

¹⁷⁹ E. Eberhartinger/M. Six, 'Taxation of Cross-Border Hybrid Finance: A Legal Analysis' (2009) Intertax, Vol 37, Issue 1, p. 4.

¹⁸⁰ Case C-28/95 *Leur-Bloem* [1997] ECR-4161, para. 44.

¹⁸¹ Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, para. 43.

¹⁸² However, the possibility of a new justification reason, the reason of preventing hybrid mismatch arrangement might be considered later in the Court's case law but it is definitely too early for that kind of assumption. See Ramon Tomazela Santos, 'Prevention of Hybrid Mismatches as a Justification?', in *Non-Discrimination in European and Tax Treaty Law*, edited by Kasper Dziurdz and Christoph Marchgraper (Linde Publication 2015), p. 163-194.

3.3.2 Coherence of the Tax System

The Court has accepted the need to safeguard the cohesion, or coherence, of the national tax system as a justification of a restrictive measure.¹⁸³ However, the argument has only been considered to apply to the same taxpayer and not for the purpose of establishing less favourable conditions for foreign subsidiaries.¹⁸⁴ Thus, whenever the argument has been successfully applied, the taxpayer has been the one and same person.¹⁸⁵ Such cohesion is not applicable when subsidiaries in one Member State owned by a parent in another State are treated less favourably than other companies and no other means are present to offset such treatment.¹⁸⁶ Due to the fact that a deduction¹⁸⁷ in the hands of a subsidiary is not generally granted on the basis of anticipated taxation of the same company, or any other, should not justify the anti-hybrid measure based on the PSD.¹⁸⁸ Furthermore, a tax exemption in the hands of the parent company is not granted on the basis of the correspondence principle. These situations do not relate to taxation of the same legal person that would otherwise be granted the domestic tax benefit.¹⁸⁹

However, the Court has analysed the cohesion of tax system from a broader point of view in *Danner*.¹⁹⁰ It is therefore a weak possibility that the Court could establish a direct link between the deductibility of the compensation derived from the mismatch arrangements at the level of the subsidiary and the taxation of the corresponding amount at the level of the parent.¹⁹¹ AG Kokott attempted to establish in *Manninen* such an immediate link between the coherence of the tax system and the single tax principle observing that it “*generally means no more than avoiding double taxation or ensuring that income is actually taxed, but only once (the principle of only-once taxation)*.”¹⁹² However, both *Danner* and *Manninen* are individual tax cases where the issue regards *the same taxpayer* but the circumstances of hybrid mismatch arrangements regards two independent taxpayers. It has been raised by *M. Helminen* that the Court in *Marks & Spencer* considered the symmetrical treatment of group profits and group losses in the same tax system, taken together with the need of preventing tax avoidance and the risk of double use of losses, can justify a restrictive measure even if the losses and the profits do not concern the same taxpayer.¹⁹³ She argues that “*it seems that the Court considers that the required link exists even if the tax burden and the tax benefit do not relate to the same taxpayer, provided they relate to the same income or the same economic process.*”¹⁹⁴ These

¹⁸³ First accepted in C-204/90 *Bachmann* [1992] ECR I-249.

¹⁸⁴ Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779, para. 41; Case C-35/98 *Verkooijen* [2000] ECR I-4071, paras. 56-58; Case C-319/02 *Manninen* [2004] ECR I-7477, para. 48.

¹⁸⁵ J. Bundgaard, ‘*Hybrid Financial Instruments and Primary EU Law – Part 2*’, (2013) *European Taxation*, Vol. 53, No 12, p. 589.

¹⁸⁶ *Ibid.*, p. 589.

¹⁸⁷ See, Case C-168/01 *Bosal Holding BV* [2003] ECR I-9409; Case C-471/04 *Keller Holding* [2006] ECR I-2107.

¹⁸⁸ J. Bundgaard, ‘*Hybrid Financial Instruments and Primary EU Law – Part 2*’, (2013) *European Taxation*, Vol. 53, No 12, p. 589.

¹⁸⁹ *Ibid.*

¹⁹⁰ See, Case C-136/00 *Danner* [2002] ECR I-8147.

¹⁹¹ Ramon Tomazela Santos, ‘*Prevention of Hybrid Mismatches as a Justification?*’, in *Non-Discrimination in European and Tax Treaty Law*, edited by Kasper Dziurdz and Christoph Marchgraper (Linde Publications 2015), p. 177.

¹⁹² Case C-319/02 *Manninen* [2004] ECR I-7477, Opinion of AG Kokott, para. 51.

¹⁹³ M. Helminen, ‘*EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements*’ (2015) *British Tax Review*, Issue 3, p. 335-336.

¹⁹⁴ *Ibid.*, p. 336.

potential observations of the Court are misleading as well as threatening the right and the protection of taxpayers since they are separate legal persons. At least, if the Court will in the nearest future establish such immediate link it must have reasonable arguments for it and the *Marks & Spencer* case¹⁹⁵ cannot be seen as reliable precedent since the Court does not reason this potential link in more details in its judgement.

A tax exemption in the hands of the parent company is not granted on the basis of corresponding taxation in the source State and does not relate to taxation of the same taxpayer that would otherwise be granted the domestic tax advantage.¹⁹⁶ Additionally, if coherence of the tax system would be accepted as a justification, the situations of hybrid mismatch arrangements would be require to be examined by the *overall approach*.¹⁹⁷ Such approach would differ from the traditionally *per-country approach* like argued before (3.2.3).

Ultimately, Member States cannot rely on the cohesion of national tax systems since it would wrongfully ignore the basic features of EU law, such as fiscal sovereignty, the right to use tax planning and the disparities in the area of direct taxation.¹⁹⁸ It is therefore highly unlikely that the Court would accept a justification reason based on coherence of the tax system.

3.3.3 Balanced Allocation of the Power to Impose Taxes

After *Marks & Spencer*, the balanced allocation of the power to tax has been an important justification under EU law.¹⁹⁹ The Court for the first time accepted this argument in *Marks & Spencer* but combined it with three conditions.²⁰⁰ Firstly, the profits and losses are two sides of the same coin and should hence be treated symmetrically to ensure a balance allocation of taxing rights. Secondly, the prevention of double utilization of the same loss is a justifiable reason and thirdly, the risk of tax avoidance if the loss was taken into consideration in the subsidiary State. In accordance with Court's case law this justification must be combined with other justification reasons. Like seen in *Oy AA* where this reason was combined with the prevention of abuse and in *Lidl* where it was combined with double utilization of losses. Therefore, it cannot as a standalone argument justify a restriction on the fundamental freedoms. The purpose with this kind of justification seems to neutralize potential advantages from a mismatch of the legal system and characterization practises of two or more different Member States.²⁰¹ The purpose is therefore not to ensure taxing rights to activities carried out in another Member State and by analogy, such would be the case with hybrid mismatch arrangements. Hence, the State of the parent company cannot ensure its taxing rights by relate the taxation to the subsidiary business activity. It therefore remains highly doubtful that the Court would agree on this justification ground.

¹⁹⁵ Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, paras. 43, 49, 51 and 57.

¹⁹⁶ J. Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 2', (2013) *European Taxation*, Vol. 53, No 12, p. 589.

¹⁹⁷ M. Helminen, 'EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements' (2015) *British Tax Review*, Issue 3, p. 336-337.

¹⁹⁸ Ramon Tomazela Santos, 'Prevention of Hybrid Mismatches as a Justification?', in *Non-Discrimination in European and Tax Treaty Law*, edited by Kasper Dziurdz and Christoph Marchgraper (Linde Publications 2015), p. 176.

¹⁹⁹ J. Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 2', (2013) *European Taxation*, Vol. 53, No 12, p. 589.

²⁰⁰ Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, para. 43.

²⁰¹ J. Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 2', (2013) *European Taxation*, Vol. 53, No 12, p. 589.

3.3.4 Prevention of Double Use of Losses - Double Non-Taxation

The prevention of double use of losses (*double dip*), justification ground accepted in *Marks & Spencer*, involves possible deduction of losses at the parent and as well at the subsidiary level. At first glance this justification ground might be considered relevant in the context of anti-hybrid rules where double benefits may arise by way of simultaneous deduction and tax exemption in the hands of different taxpayers.²⁰² To the contrary, in *Philips Electronics*²⁰³ the Court did not accept the risk of double utilization of losses. Therefore, based on the *Philips Electronics* case, it might be argued that in the context of hybrid financial instruments that tax treatment in the subsidiary State (*debtor/payer*) cannot justify the denial of exemption in the resident State (*creditor/payee*).²⁰⁴ Hence, the presumption that the objective of preventing the double use of losses cannot successfully justify anti-hybrid rules which disallow a participation exemption in the parent State.²⁰⁵ As well, the ECJ seems only to allow this justification reason where there is a direct link to the activities carried out in the territory of the Member State in question²⁰⁶ and such is not the case with hybrid financial instruments. Furthermore, in *Aberdeen*²⁰⁷ the Court specifically mentioned that double non-taxation does not justify a restriction as well as offsetting the low taxation of another State.²⁰⁸ This indicates that since tax systems of EU Member States are not harmonized, a Member State is not allowed to neutralize the tax advantages provided by the other Member State(s) if such a neutralizing provision would mean a restriction on the TFEU freedoms.²⁰⁹ Hence, prevention of double non-taxation would not be a likely justification reason accepted by the Court.

The final step of the ECJ analyse test is to examine if a justifiable discrimination and/or restriction is proportionate. Since the justification reasons provided above are considered not to be accepted by the Court, there is no need for a discussion about proportionality.

3.3.5 Final Remarks

Getting a comprehensive understanding in the discussion above, the Court seems not willing to accept restrictive and/or discriminative anti-hybrid rule based on Article 4.1(a) PSD: 1) when the arrangements are not wholly artificial; 2) if however justified by the coherence of tax systems, the situations would be required to be examined under the overall approach but such would not be in accordance to the European landscape (3.2.3); 3) as Member State cannot relate its taxation on the tax treatment in another Member State and 4) by analogy from case law regarding the prevention of double use of losses, the prevention of double non-taxation is not likely to be accepted as a justification ground like also confirmed by the Court in *Aberdeen*.

²⁰² Ibid, p. 590.

²⁰³ Case C-18/11 *Philips Electronics* [2012] ECR I-532, para. 28.

²⁰⁴ J. Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 2', (2013) *European Taxation*, Vol. 53, No 12, p. 590.

²⁰⁵ Ibid.

²⁰⁶ As can be seen from C-446/03 *Marks & Spencer* [2005] ECR I-10837, para. 43.

²⁰⁷ Case C-303/07 *Aberdeen Property Fininvest Alpha* [2009] ECR I-5145, para. 51.

²⁰⁸ As can be seen for example in C-196/04 *Cadbury Schweppes* [2006] ECR I-7995, para. 49 and in case 270/83 *Avoir Fiscal* [1986] ECR 273, para. 21.

²⁰⁹ M. Helminen, 'EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements' (2015) *British Tax Review*, Issue 3, p. 334.

Article 4.1(a) PSD in its current state cannot be justified under the rule of reason test and therefore would a national measure based on the PSD anti-hybrid rule conceivable infringe the fundamental freedoms like argued in the chapters above.

3.4 Switching from Exemption to Credit and Classification of Income (Dividend or Interest)

It has been raised that instead of disallowing exemption in the PSD, hybrid mismatch arrangements should rather be dealt with the credit method. Even though the exemption method is considered to be more in line with the objectives of the EU internal market than the credit method, the exemption method however increases the risk of double non-taxation²¹⁰ and as well, the equity/debt bias comes to consideration. Indeed, switching from the exemption to the credit method would however be in line with the single tax principle and the Court²¹¹ in *Columbus Container*²¹² endorsed the possibility to switch over exemption to credit of tax in the presence of double non-taxation. This needs however a further examination since many questions remains unanswered.

It is crucial that tax liability and what is subject to tax is well-established in domestic law. If one State considers payments to be debt while the other considers it as equity, there is a mismatch. Like foresaid, single taxation, as represented by the *League of Nations* in 1927, provides that if a State does not tax passive income in accordance to the benefit principle, the taxing power transfers to the other State. Based on that, the resident State of the parent has the authority to tax dividends as it is defined as passive income. One of the main purposes of the PSD is to abolish tax obstacles between companies of different Member States. The purpose of the PSD therefore complicates the issue since the debt/equity bias is definitely a tax obstacle for the Member States while the anti-hybrid rule is an obstacle for the taxpayers involved. Neutrality is therefore challenged under these circumstances.

Despite the fact that the single tax principle constitutes desirable tax consequences and simplicity for Member States as well as legal certainty for taxpayers, it does not solve the problem of the classification of the hybrid mismatch arrangements. It does not provide any guidance on how to characterize debt nor equity since no classifications of hybrid financial instruments as dividends generating equity and interest generating debt exists.²¹³ By not applying any guidance of how debt or equity should be characterized the application of the single tax principle seems to be difficult. To solve that problem the currently existing fundamental lack of consistency within the Union, in terms of domestic tax characterization of the remuneration derived from hybrid financial instruments, must be eliminated.²¹⁴

²¹⁰ M. Helminen, 'The Problem of Double Non-Taxation in the European Union – To What Extent Could This Be Resolved through a Multilateral EU Tax Treaty Based on the Nordic Convention?', (2013) European Taxation, Vol. 53, Issue 7, p. 309.

²¹¹ Contrary to the AG opinion, C-298/05 *Columbus Container Services* [2007] ECR I-10451, Opinion of AG Mengozzi, paras. 148-155.

²¹² Case C-298/05 *Columbus Container Services* [2007] ECR I-10451, paras. 44, 51, 53 and 54.

²¹³ Sven-Eric Barsch, *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context*, (Springer 2012), p. 96.

²¹⁴ *Ibid*, p. 323.

By applying the credit method,²¹⁵ instead of exemption, in Article 4.1(a) PSD, the debt/equity bias comes into question as well. Based on the credit method, the parent State would tax the whole received amount in accordance to its national law which would characterize the payment as dividend. Whether the exemption is disallowed or the credit method applied, would under most circumstances,²¹⁶ lead to the same conclusion.²¹⁷

However, in accordance to mentioned case laws (3.3.1), it can be argued quite decidedly that for the national anti-tax avoidance measure to be justified, the questionable arrangements need to be wholly artificial and the provision may not apply automatically without any saying of the taxpayer. What if hybrid mismatch arrangements are really genuine and reflect economic reality, and not wholly artificial? In such situations the debtor (*subsidiary*) is paying back a loan capital, with interests, to the creditor (*parent*); why should those payments be taxed in the Member State of the parent according to an anti-hybrid rule based on the PSD? And how will the parent State characterize the payments? An expense is a non-income for the distributing company (*the subsidiary*) but is an income for the receiving company (*the parent*) in the form of interest. The parent State *may* characterize the payments in two ways: first, as a profit distribution under the PSD and hence tax the whole amount or second, as an interest under the Interest and Royalty Directive²¹⁸ (IRD) and tax the received interest. The interaction between these two directives is certainly unclear.

The scope of application of the PSD is determined in Article 1.1 where each Member State applies the directive to *distributions of profits* received by companies of that State which come from their subsidiaries of other Member States. The directive has an impact on the tax treatment of distributions between related entities both in the resident State of the distributing subsidiary and in the State of resident of the receiving parent company. Such profit distribution is in general participation exempt from tax in the resident State of the parent but what defines interest payments as profit distribution under the PSD? The term “*profit distribution*” is not defined in the directive but on the other hand, it is a general understanding that the term is a somewhat broader concept than dividend.²¹⁹ Interests are defined in Article 2(a) IRD and the definition is broad as the term in general means income from debt-claims of “*every kind*.” It is therefore unreliable, even irresponsible, applying interest under the PSD as profit distribution. The PSD does not presume interest being a profit distribution. If interest income should be considered as profit distribution under the PSD it should be specifically stated in the Directive, or its legislative history, for so many reasons, as for legal certainty, as no tax may be imposed except by law (constitutional right) et cetera. However, in the proposal amending the PSD, it is stated that no withholding tax would be imposed on the

²¹⁵ Applying the underlying tax credit would indeed be more burdensome for the administrative procedure including that Member States, on the basis of unanimity for implementing a directive in accordance to Article 115 TFEU, would likely not agree with the tax credit method since the exemption method is easier in process.

²¹⁶ It is however questionable if economic double taxation could occur if three Member States would be involved, one parent State, one subsidiary and one sub-subsidiary State and therefore be opposite to the purpose of the PSD eliminating double taxation. See, Christoph Marchgraber, ‘*Tackling Deduction and Non-Inclusion Schemes – The Proposal of the European Commission*’, (2014) *European Taxation*, Vol. 54, No 4, p. 133-137.

²¹⁷ Christoph Marchgraber, ‘*Tackling Deduction and Non-Inclusion Schemes – The Proposal of the European Commission*’, (2014) *European Taxation*, Vol. 54, No 4, p. 133-137.

²¹⁸ Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (OJ L 157, 26.06.2003, p. 49-54).

²¹⁹ M. Helminen, *Chapter 2: Non-Discrimination and Basic Freedoms in EU Tax Law – Direct Taxation – 2015: 2015 Edn.* (IBFD 2015).

profits distributed by the subsidiary as the payment in the Member State of the subsidiary would be “*treated as interest payment under the IRD*” and hence be exempted of withholding tax in the source State.²²⁰ The proposal noticeably only focused on clear equity/debt situations. This is not so simple since Article 4.1 of the IRD allows the source State to *exclude* payments, like for instance financial hybrid instruments, from the scope of the Directive. The payment is however considered to be a deductible cost for the subsidiary but the source State (*subsidiary State*) has the right to tax the payment with withholding tax. The subsidiary can end up paying a withholding tax and the payment received by the parent company is taxed in the parent State. Even if the parent State would grant a tax credit for the taxes paid in the subsidiary State the total tax amount *may* exceed the corporate income tax in the parent State. This ultimately leads to a juridical double taxation. If Article 4.1(a) PSD would be amended with the credit method, it would neither be in line with ECJ case law since it would apply to arrangements which are indeed genuine.

Hence, if everything is compiled, switching over to the credit method from exemption does not seem to be a solution regarding taxation of hybrid financial instruments and would additionally upset the single tax principle since it would not be in accordance to EU law.

4 Proposed Solution of Measures for the Avoidance of Double Non-Taxation: Could GAAR Be the Only Option to Secure Single Taxation?

From an EU law perspective, concurrent application of different autonomous domestic classification principles is generally acceptable. The difference lies in the natural consequences of the concurrent exercise of the taxing rights of Member States in the absence of harmonization measures. There are no legal remedies based on primary law that could result in any consequences for companies within EU.²²¹ Hence, companies should be free to decide and take the advantage of different classifications of hybrid financial instruments between Member States.

Based on the distinction between debt and equity capital for tax purposes and the involvement of more than just one tax jurisdiction, different tax classifications of hybrid financial instruments and the remuneration derived therefrom under the respective (*domestic*) tax rules in the involved Member States may distort single taxation. Return on equity capital is usually only subject to tax in the source country (*corporate income tax and withholding tax*) where the profit distributing company is resident, while return on debt capital is normally only subject to tax in the residence country where the interest receiving company is resident. Hence, the tax classification as interest-generating debt or dividend-generating equity is crucial for the allocation of taxing rights.²²²

Referring to *Chapter 3.1*, the single tax principle requires that if the preferred jurisdiction curbs from taxing the income, then the other jurisdiction should tax to prevent double non-

²²⁰ Commission, ‘Proposal for Council Directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States’ COM(2013) 814 final, p. 7.

²²¹ J. Bundgard, ‘*Hybrid Financial Instrument and Primary EU Law – Part I*’, (2013) *European Taxation*, Vol. 52, No 11, p. 546.

²²² Sven-Eric Barsch, *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context*, (Springer 2012), p. 25.

taxation.²²³ At first glance, it can be observed that by denying participation exemption that single taxation is fulfilled since the subsidiary State does not tax the payments and the Member State of the parent gets the right to tax. However, after further examination, there are relevant arguments that two elements are missing for the principle to withstand in counteracting hybrid mismatch arrangements. The arrangements would either need to be counteracted by GAAR, and hence only apply to wholly artificial arrangements, or that definitions of equity and debt would be harmonized within EU.

By applying the interest received by the parent company under the GAAR in Article 2.1 PSD in the former solution, as disguised or hidden dividend distribution erasing tax base in the Member State of the parent, the payment could be considered as profit distribution and therefore constitute a taxable income in the State of the parent. Such would lead to re-characterization of transactions between related companies within different Member States.

On the other hand, reclassifying interest payments to foreign companies as dividends indeed adds the risk that genuine loans between the related companies which are within an arm's length would be reclassified as well.²²⁴ As well, it is clear from ECJ case law that the burden of proof lies with the domestic tax authorities and that the taxpayer should be given the opportunity to provide proof that the debatable transactions are commercial justified.²²⁵ Neither of this is secured in the PSD anti-hybrid rule. The Court's decision on *Cadbury Schweppes* implies that Member States are allowed to enact rules aiming at hindering transfers of taxable profits out of a country in an artificial manner.²²⁶ The Court identified the circumstances required in order for a transfer of profits to qualify as wholly artificial arrangements.²²⁷ First, a subjective element is required where the intention is of achieving a tax advantage. Second, it must be evident from the objective circumstances that no genuine establishment has been made and that no actual business is being conducted in other Member States and third; among such objectively verifiable circumstances are the extent of the company's physical presence, such as building, staff and equipment in the host country.²²⁸ Hence, there must be an intention of tax avoidance and the national provision has to indicate such in its wording.²²⁹ None of these elements, established by the Court, can be found in the PSD anti-hybrid rule and that supports that the rule infringe EU law.

By using GAAR instead of the anti-hybrid rule, arrangements that would be considered artificial under the rule would be re-characterized as such and therefore the disguised profit distribution in the form of a loan provided from a parent company in one Member State to a subsidiary in another would be characterized as dividend resulting in taxation in the Member

²²³ Reuven S. Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar Publishing 2015), p. 108.

²²⁴ Case C-524/04 *Test Claimants in the Thin Gap Group Litigation* [2007] ECR I-2107, para. 81; Case C-105/07 *NV Lammers & Van Cleeff* [2008] ECR I-173, para. 30.

²²⁵ Case C-524/04 *Test Claimants in the Thin Gap Group Litigation* [2007] ECR-2107, para. 82; Case C-201/05 *Test Claimants in the CFC and Dividend Group Litigation* [2008] ECR I-2875, para. 84; Case C-311/08 *SGI* [2010] ECR I-487, para. 71.

²²⁶ M. Hilling, 'Justifications and Proportionality: An Analysis of the ECJ's Assessment of National Rules for the Prevention of Tax Avoidance', (2013) *Intertax*, Vol. 41, Issue 5, p. 296.

²²⁷ Case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995, para. 64.

²²⁸ Case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995, para. 67; cf. M. Hilling, 'Justifications and Proportionality: An Analysis of the ECJ's Assessment of National Rules for the Prevention of Tax Avoidance', (2013) *Intertax*, Vol. 41, Issue 5, p. 297.

²²⁹ Case C-282/12 *Itelcar* [2013] ECR I-0000, para. 43.

State of the parent. The disguised profit would therefore be taxed only once and would therefore fulfil the single tax principle.

As well, by harmonizing the debt/equity bias and have a common definition of those concepts, single taxation is likely to be secured in conformity with EU law. If so, there would not be any mismatches between jurisdictions since both jurisdictions involved would consider the transaction either to be debt or equity. However, if the transactions would involve third State jurisdiction, outside EU, that would not define debt or equity in the same manner as the EU Member States, a mismatch could occur. Harmonizing concepts like debt and equity within EU is a huge and indeed complex assignment and raise doubts that 28 Member State could ever agree on concrete definitions of these terms. This solution is therefore quite farfetched and not likely to be accepted within EU.

Referring to the arguments above, it is concluded that the GAAR rule is the only relevant option to secure single taxation of hybrid mismatch arrangements that would be in line with EU law and for this reason there would be no need for special anti-hybrids rules, neither in the PSD nor in the ATA Directive Proposal.

5 Conclusion

It is highly doubtful that double non-taxation is a matter of EU law since EU primary law does not indicate anything about that Member State should avoid double taxation or double non-taxation. It can be argued, since the ECJ does not seem to care about juridical double taxation, the Court should not care about double non-taxation as these are the different sides of the same coin.

After examining how the Court analyses whether the TFEU freedoms are discriminated by national law it is more likely than not that the Court would be consistent with its earlier case law and examine the hybrid situations under *the per-country approach* instead of the overall approach. The former approach is more in line with EU landscape and likelier to give the result that the measure in question breaches the fundamental freedoms. It has also been stated by the Court that if a national measure has the *possibility* to hinder or restrict the freedoms and if certain conditions are not fulfilled, than the debatable measure could be considered as a violation of EU law. Hence, there are reasonable arguments that a national measure, based on the PSD anti-hybrid rule, would be considered to infringe EU law.

The discrimination and/or restriction could *not* be justified according to now established case law. Hence, there was no need to examine whether the measure would be considered to be proportionate or not.

Switching from exemption to the credit would upset the single tax principle and as well as it could affect taxation based on the IRD. As Member State of the parent would either consider the hybrid payment to be dividend under the PSD or interest under the IRD, it is also observed that interest could not be classified as profit distribution under the PSD without any clear wording in the directive text or in its legislative history. The only way for interest to be taxed as dividend under the PSD is if the arrangements would be examined under the PSD GAAR as disguised profit.

The only way to prevent double non-taxation of hybrid mismatch arrangements should be with single taxation. For the principle to comply with EU law it is concluded that the

arrangements should be examined under a GAAR, for example like provided in the PSD, by addressing a subjective measure to the situations. If so, then there would be no need for a special anti-hybrid rule since the general anti-avoidance rule would apply. This would be in line with the Courts case law which states that Member States cannot restrict the TFEU freedoms if the arrangements in question are based on reality and are deviated from commercial activity. On the other hand, if wholly artificial, then national measures can restrict the freedoms since the behaviour of the taxpayer and aim of the transactions would be to circumvent jurisdictions with the intension of avoiding tax payments. Accordingly, the source State of the profit would approximately be the State of the parent which had distributed equity under disguised manner as a loan for skipping tax payments and getting the equity back from its subsidiary in form of interest. The interest would then be re-characterized as dividend since the interest payment would be considered to be disguised profit distribution. The disguised dividend would then be taxed in the Member State of the parent. Secondly, if relying on the single tax principle without the GAAR it is considered necessary to harmonize the characterization of the concepts of both debt and equity. Such would be a crucial element for the single tax principle to apply. It is though considered to be doubtful that 28 EU Member States can and will agree with common definitions of the terms. For this reason, it is concluded that the GAAR seems to be to the only relevant solution to secure single taxation of hybrid mismatch arrangements within EU.

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