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## **Neutralizing the Effects of Hybrid Mismatch Arrangements on a EU Level**

To what extent can Member States be obliged to align their  
tax systems to each other?

by

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## List of Abbreviations

|       |   |
|-------|---|
| Art.  | Article   |
| ATAD  | Anti-Tax Avoidance Directive                                |
| BEPS  | Base Erosion and Profit Shifting                            |
| CFC   | Controlled Foreign Company                                  |
| Ch.   | Chapter   |
| CJEU  | Court of Justice of the European Union                      |
| DTC   | Double Taxation Convention                                  |
| ECR   | European Court Reports                                      |
| EFTA  | European Free Trade Association States                      |
| EU    | European Union  |
| G20   | Group of 20   |
| GAAR  | General Anti-Abuse Rule                                     |
| Ibid. | Ibidem  |
| MFN   | Most-Favoured-Nation  |
| MNE   | Multi-National Enterprise                                   |
| n.    | (Foot-)note   |
| no.   | number  |
|       | OECD Organisation for Economic Co-operation and Development |
| p.    | page  |
| para. | paragraph   |
| PSD   | Parent-Subsidiary Directive                                 |
| TEU   | Treaty on European Union                                    |
| TFEU  | Treaty on the Functioning of the European Union             |
| vs.   | versus  |
| Vol.  | Volume  |

## Summary

Due to the on-going discussion regarding the OECD/G20 BEPS project and its particular actions it is an important task for the EU legislator to establish a reasonable and functional legal framework in order to ensure a certain degree of uniformity of Anti-BEPS measures within the European Union. In doing so, the protagonists must respect the boundaries set to domestic law as well as to measures of secondary legislation by primary EU law.

With regard to hybrid financial instruments the European Commission recently made efforts in order to align the tax treatment of hybrid payments between Member States. These efforts include particular amendments to the Parent-Subsidiary Directive as well as a specific provision on this subject in the recently proposed Anti-Tax Avoidance Directive. Even though the concepts used in both Directives may differ, the targeted result is, in any case, the alignment of the legal systems of two Member States in order to achieve symmetrical taxation of hybrid financial instruments. From a EU law perspective, however, it can be questioned whether such an alignment meets the requirements of primary law. The case law of the CJEU on the interpretation of the fundamental freedoms provided for by the TFEU demonstrates considerably potential inconsistencies. Whenever the application of linking rules would leave a taxpayer in a less favourable situation, its right of free movement might be infringed. It is not reasonable for the CJEU to take into account deviating tax consequences in another Member States. Neither is it the competence of the CJEU to rule about double taxation or double non-taxation as both phenomena are simply the consequence of differences in the Member States tax systems. Due to the lack of harmonization in the field of direct taxation such disparities are not assessable in the light of EU law. It can further not be assumed that an infringement of the fundamental freedoms caused by linking rules can be justified by overriding reasons of public interest.

The target pursued by linking rules, namely, to prevent double non-taxation by ensuring that every income is taxed once somewhere, does not fit in the current legal landscape of the EU as it undermines the sovereignty of the Member States. As long as the CJEU refuses to interpret the fundamental freedoms as not prohibiting double taxation, restrictive measures with the aim to tackle double non-taxation, which have their origin in the different tax systems, cannot be justified by overriding reasons of public interest. It will be seen whether or not the CJEU will acknowledge linking rules and the alignment of Member States tax systems as an appropriate measure. Without any doubt, a case will find its way to the CJEU in the near future.

# 1 Introduction

## 1.1 Background

Due to the lack of harmonization in the field of direct taxation it remains to the sovereignty of each Member State to implement its own legal framework in this area of law.<sup>1</sup> In doing so, Member States must exercise the powers retained to them in consistency with primary law.<sup>2</sup> Notwithstanding this obligation to respect the principles of European Union (EU) law and particularly the fundamental freedoms, differences in tax systems are the results of the competences conceded to the Member States. In cross-border situations, the interaction of such independent sets of rules enforced by sovereign States can lead to both double taxation and double non-taxation as there is no general principle of coherence on an international level.<sup>3</sup> With regard to cross-border financing, in particular, these differences can lead to different characterizations of the same financial instrument by the Member States involved (qualification conflict).<sup>4</sup> As a result, one State may characterize an instrument as debt while the other State treats it as equity.

The tax treatment of debt and equity differs fundamentally in most Member States' tax systems. While debt is regarded as a resource that does not belong to a company and for the use of which the company has to pay, equity is, by contrast, regarded as a resource that is owned by the company itself.<sup>5</sup> As a consequence, the remuneration paid for the use of borrowed capital is a deductible business expense and reduces the taxable base, whereas dividends that are paid to shareholders, who provide a company with equity, are not deductible. Because of these differences in tax treatment of debt and equity, the divergent qualification of financial instruments by two Member States can be used by Multi-National Enterprises (MNEs) in a targeted way to reduce their tax base.

A lot of attention has already been paid to these so-called hybrid mismatch arrangements, especially by the Organisation for Economic Co-operation and Development (OECD).<sup>6</sup> Together with the G20 the OECD developed the so-called Base Erosion and Profit Shifting (BEPS) Project of which the final report was published on the 5<sup>th</sup> of October 2015. This report includes, among other things, guidelines regarding the neutralization of hybrid mismatch arrangements and their

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<sup>1</sup> Only few areas have been harmonized in the field of direct taxation: Parent-Subsidiary Directive (2011/96/EU) see also n. 9; Merger Directive (2009/133/EC); Interest and Royalties Directive (2003/49/EC); Savings Directive (2003/48/EC); Directive on Mutual Assistance (2011/16/EU); EU Arbitration Directive (90/436/EEC).

<sup>2</sup> CJEU, 14. Feb. 1995, C-279/93, *Schumacker*, ECR [1995] I-249, para. 21.

<sup>3</sup> OECD, *Action Plan on Base Erosion and Profit Shifting (2013)* (OECD Publishing, Paris, 2013), p. 9.

<sup>4</sup> Raffaele Russo, *Fundamentals of International Tax Planning* (IBFD 2007), p. 125.

<sup>5</sup> *Ibid.*, p. 107.

<sup>6</sup> OECD, *Addressing Tax Risks Involving Bank Losses* (OECD Publishing, Paris, 2010); OECD, *Corporate Loss Utilisation through Aggressive Tax Planning* (OECD Publishing, Paris, 2011); OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD Publishing, Paris, 2012); OECD, *Action Plan on Base Erosion and Profit Shifting (2013)*.

adverse effects for States' tax revenues.<sup>7</sup> Since many of the OECD Members are, at the same time, Member States of the EU,<sup>8</sup> it was highly discussed by scholars whether the individual BEPS recommendations are in conflict with EU law. The efforts of the OECD regarding the BEPS project would be of limited significance if the particular measures would prove to be incompatible with the fundamental freedoms as every Member State has to respect them while implementing them into their domestic law.

The European Commission already took action in order to secure a certain degree of harmonization and a uniform implementation of Anti-BEPS measures on a EU level. These actions include, first, particular amendments of the Council Directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (PSD).<sup>9</sup> Further, and most recently, the European Commission published an Anti-Tax Avoidance Package that contains concrete measures to combat aggressive tax planning on a EU level.<sup>10</sup> An essential component of this package is the proposal for a Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (hereinafter Anti-Tax Avoidance Directive, ATAD).<sup>11</sup> The ATAD responds directly to the OECD/G20 BEPS Project and aims to achieve a stronger and more coherent approach against corporate tax abuse within the EU.<sup>12</sup> This also includes, inter alia, measures to tackle the adverse effects of hybrid financial instruments.<sup>13</sup> As secondary law must also be compatible with primary law<sup>14</sup> it is worth examining whether conflicts could be identified

## 1.2 Aim

Neither the discussion on the problems and opportunities caused by hybrid mismatch arrangements, nor the discussion about the EU compatibility of Anti-BEPS measures is new in academic literature. The recent amendments of the PSD as well as the proposal for the ATAD, however, give raise to discussions on the compatibility of secondary law measures adopted by EU institutions on this subject.

De lege lata, Art. 4.1(a) PSD provides for a denial of the exemption of dividend income in the Member State of the payment receiving company (Residence State) to the extent that this payment was regarded as a deductible business expense in the Member State of the issuing company (Source State). According to the proposed Art. 10 ATAD, on the other hand, the Residence State would de lege ferenda be obliged to follow the legal

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<sup>7</sup> OECD, *OECD/G20 BEPS Project: Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report* (OECD Publishing, Paris, 2015).

<sup>8</sup> Current EU Member States that are also members of the OECD: Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, United Kingdom.

<sup>9</sup> 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 (recast), OJ L 345/8. In particular Art. 4.1(a).

<sup>10</sup> 'Anti Tax Avoidance Package' (*European Commission*, 28.01.2016) [http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/anti\\_tax\\_avoidance/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/anti_tax_avoidance/index_en.htm) accessed 15. May 2016.

<sup>11</sup> 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, 28.1.2016.

<sup>12</sup> *Ibid.*, p. 3.

<sup>13</sup> See Art. 10 ATAD.

<sup>14</sup> See Ch. 3.2.

characterization given to a payment by the Source State, if otherwise a situation of double non-taxation occurs. This can lead to the particular situation in which the Residence State re-characterizes tax exempt dividend income into taxable interest income and, therefore, create a disadvantageous treatment for its resident companies with regard to their foreign investments.

In a nutshell, both the new Art. 4.1(a) PSD and Art. 10 ATAD provide for an alignment of tax treatment of certain (hybrid) payments by either denying the exemption of income or by re-characterizing tax exempt income into taxable income in order to avoid double non-taxation. It appears questionable whether this alignment of tax treatments can be regarded as compatible with primary EU law, particularly, the fundamental freedoms. The purpose of this thesis is therefore to analyse whether, and to what extent, one Member State can make the tax treatment of certain payments dependent upon the tax treatment of the same payment by another Member State.

### 1.3 Method and Material

As the underlying legal question, which is discussed in this thesis, is whether there is a conflict between two different sources of law, an internal, legal-dogmatic research method appears to be the most appropriate. *Vranken* states that “*legal-dogmatic research concerns researching current positive law as laid down in written and unwritten European or (inter)national rules, principles, concepts, doctrines, case law and annotations in the literature.*”<sup>15</sup> This research method normally consists of two separate parts. First, all the relevant sources of law have to be determined and second, these sources are to be interpreted, analysed, systemized and confronted with each other.<sup>16</sup>

In applying this research method, the law that is scrutinized shall be presented as it stands. Therefore, it is, first of all, important to provide appropriate definitions on the notion *hybrid financial instruments* established by literature and official institutions. Subsequently, and in order to explain the particular provisions which are subject of discussion, a closer look will be put the ATAD. The author is aware of the on-going discussion regarding the final version of the ATAD and the fact that, until this thesis was finalized,<sup>17</sup> the competent authorities could not reach a common consensus. This thesis will therefore solely focus on the ATAD in its version as of the 28<sup>th</sup> January 2016, its supporting documents and the already existing literature. As the ATAD can, however, not be regarded as a valid source of law, the particular provisions of the PSD are discussed additionally since the overall legal questions arising from the alignment of legal treatments by sovereign Member States remains the same.

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<sup>15</sup> Jan Vranken, ‘Exciting Times for Legal Scholarship’ [2012] *Recht en Methode in onderzoek en onderwijs*, p. 42, 43.

<sup>16</sup> Terry Hutchinson and Nigel Duncan, ‘Defining and Describing What We Do: Doctrinal Legal Research’ [2012] Vol. 17, *Deakin Law Review*, p. 83, 110; Sjoerd Douma, *Legal Research in International and EU Tax Law* (Kluwer 2014), p. 20.

<sup>17</sup> The 3<sup>rd</sup> June 2016.

In examining whether the linkage of the tax treatment of hybrid financial instruments proposed by the European Commission is compatible with primary EU law it will be referred to the applicable provisions in the EU Treaties (TEU<sup>18</sup> and TFEU<sup>19</sup>) as well as the case law of the Court of Justice of the European Union (CJEU). The mentioned legal sources set boundaries to domestic legislation of the EU Member States as well as to secondary EU law by means of positive and negative integration.<sup>20</sup> The EU Treaties will be examined in order to present the applicable legal basis on which EU taxpayers could rely when their fundamental freedoms are restricted. As there is not yet any case law on this topic, the CJEU's case law on other occasions, which provides for useful guidance, will be analysed. The case law was selected by focusing on the particular situation in which the mentioned linking rules would apply. As both the PSD and the ATAD provide for a limitation of the exemption of dividend income in the Residence State, the CJEU's case law on inbound dividends will provide guidance on the Court's interpretations in this context. Also in other occasions the CJEU had to decide about the influence that the tax treatment of a Member State could have on the discriminatory tax treatment caused by another Member State. Therefore, relevant case law, which contains valuable statements on this subject, will also be taken into account. The literature in the form of books, journal articles and doctrinal debates is selected objectively and based on a comprehensive research activity in the field of hybrid mismatch arrangements, tax arbitrage and prevention abusive practices. Arguments for and against the EU compatibility of linking rules are taken into account in order to provide the reader with an objective understanding of the problem and the conducted debate. All sources will be interpreted in the course of their wording and their purpose.

#### 1.4 Delimitations

This contribution shall not provide for an analysis of the OECD BEPS project as such but will focus solely on the linking rules in secondary legislation and the fundamental EU law questions which arise in this context. This thesis will further not examine the particular provision on hybrid entities but will only focus on hybrid financial instruments. The impact of Double Taxation Conventions (DTC) shall also be disregarded.<sup>21</sup> Only if necessary a particular reference will be made. Additionally, the conflict of hybrid mismatch rules in domestic law in connection with the prohibition of state aid will not be examined in this thesis.<sup>22</sup>

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<sup>18</sup> Consolidated version of the Treaty on European Union - Protocols - Declarations annexed to the Final Act of the Intergovernmental Conference which adopted the Treaty of Lisbon, signed on 13 December 2007, OJ C 326, 26.10.2012, p. 1 - 390.

<sup>19</sup> Consolidated version of the Treaty on the Functioning of the European Union - Protocols - Annexes - Declarations annexed to the Final Act of the Intergovernmental Conference which adopted the Treaty of Lisbon, signed on 13 December 2007, OJ C 326, 26.10.2012, p. 1 - 390.

<sup>20</sup> Łukasz Adamczyk, 'The Sources of EU Law Relevant for Direct Taxation' in Michael Lang and others (eds), *Introduction to European Tax Law on Direct Taxation* (3rd edn, Linde 2013), p. 24.

<sup>21</sup> See for further considerations in this regard Eva Eberhartinger and Martin Six, 'Taxation of Cross-Border Hybrid Finance: A Legal Analysis' [2009] Vol. 37, *Intertax*, p. 4, 6 et seq.

<sup>22</sup> See in this regard Marjaana Helminen, 'EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements' [2015] *British Tax Review*, p. 325, 328.



## **1.5 Outline**

Following these introductory remarks, essential statements and necessary definitions shall be provided on the term hybrid mismatches (2). Subsequently, a comprehensive overview on the ATAD proposal is presented (3). That includes statements about the background as well as the subjective and objective scope of the directive in order to make the reader aware of the legal framework that shall potentially be covered by it. Also the interaction of the ATAD with the PSD is subject of discussion. A strong emphasis will be put on the analysis of the linking rules in the light of the basic freedoms provided for by the TFEU (4). Following a short introduction the applicable freedom is going to be established. The analysis continues with the examination of a possible discrimination in the light of the CJEU's case law. The investigation proceeds with the question whether a potential restriction can possibly be justified by overriding reasons of public interest. Finally, a summarizing conclusion of the findings obtained will be provided (5).

## 2 Hybrid Mismatches

The OECD refers to hybrid mismatches as arrangements exploiting differences in tax treatment of instruments, entities, dual resident entities or transfers between two or more countries.<sup>23</sup> The now published ATAD proposal is rather simple as it focuses only on hybrid entities and hybrid financial instruments without concentrating on all particularities as identified by the BEPS report.

Hybrid entities can be defined as legal entities that are treated as a separate, opaque taxable person under the tax system of one jurisdiction while they are treated as ‘transparent’ entities in another jurisdiction.<sup>24</sup> Since this thesis will however mainly focus on hybrid financial instruments, a more detailed definition and possible appearances of hybrid entities will not be provided.<sup>25</sup>

As regards the term *hybrid financial instruments* a general definition does not exist today.<sup>26</sup> Also the OECD in its BEPS report on Action 2 avoids to provide a comprehensive, detailed definition of the term as there is a wide variety of financial instruments and structures and the ways sovereign jurisdictions treats them for tax purposes differ enormously.<sup>27</sup> According to *Russo* hybrid financial instrument can be defined in a general way as a “*form of financing that is treated differently by the tax systems of the country receiving the finance and by that of the country providing it.*”<sup>28</sup> In the context of the amendments to the PSD<sup>29</sup> the term *hybrid loan arrangement* was defined as a financial instrument that has the characteristics of both debt and equity.<sup>30</sup> Due to the different tax treatment of debt and equity one Member State may treat a hybrid loan as deductible expense while the other Member State treats the same transaction as a tax exempted profit distribution.

Naturally, hybrid financial instruments do not only occur in situations where one Member State qualifies the instrument as debt while the other Member State qualifies it as equity. Also a qualification of something that is between debt and equity is possible.<sup>31</sup> For the purpose of this thesis, however, the focus will be put on this classical qualification conflict that was also identified by the European Commission.

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<sup>23</sup> OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, (supra n. 6), p. 7.

<sup>24</sup> Russo, *Fundamentals of International Tax Planning*, (supra n. 4), p. 133.

<sup>25</sup> See in this regard Russo (supra n. 4), p. 133 et seq and Raffaele Russo, ‘Partnerships and Other Hybrid Entities and the EC Corporate Directives’ [2006] *European Taxation*, p. 478. See also regarding the differences in characterization of partnerships John F. Avery Jones, ‘Characterization of Other States’ Partnerships for Income Tax’ [2002] Vol. 56, *Bulletin for International Taxation*, p. 288.

<sup>26</sup> Christian Kahlenberg and Agnieszka Kopec, ‘Hybrid Mismatch Arrangements – A Myth or a Problem at Still Exists?’ [2016] *World Tax Journal*, p. 37, 39.

<sup>27</sup> OECD, *OECD/G20 BEPS Project: Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, no. 14.

<sup>28</sup> Russo, *Fundamentals of International Tax Planning*, (supra n. 4), p. 124.

<sup>29</sup> See in detail Ch. 3.1.3.

<sup>30</sup> Proposal for a Council Directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, COM(2013) 814 final, 25.11.2013, p. 2.

<sup>31</sup> See in detail Russo, *Fundamentals of International Tax Planning*, (supra n. 4), p. 124 et seq. See also in this context for a very comprehensive literature overview Kahlenberg and Kopec, ‘Hybrid Mismatch Arrangements – A Myth or a Problem at Still Exists?’, (supra n. 26), p. 39 et seq;

### 3 The Anti-Tax Avoidance Directive Proposal on Hybrid Mismatch Arrangements

On the 28<sup>th</sup> January 2016, the European Commission published its Anti-Tax Avoidance package.<sup>32</sup> As one of the constituent parts of this package, the proposal for the ATAD aims to lay down rules against tax avoidance practices that are capable to directly affect the functioning of the internal market.<sup>33</sup> In this regard, the proposal contains six particular anti-tax avoidance rules, namely deductibility of interest, exit taxation, a switch-over clause, a general anti-abuse rule (hereafter GAAR), controlled foreign company (hereafter CFC) rules and also a framework to tackle hybrid mismatches. The following chapter shall provide an overview on the most important information regarding the background, applicability and the scope of the ATAD but only in connection to hybrid mismatch arrangements, in particular, hybrid financial instruments. For that reason the current version of Art. 10 ATAD on hybrid financial instruments shall be put first of which the wording is as follows:<sup>34</sup>

*Where two Member States give a different legal characterisation to the same payment (hybrid instrument) and this leads to a situation where there is a deduction in the Member State in which the payment has its source without a corresponding inclusion of the same payment in the other Member State, the legal characterisation given to the hybrid instrument by the Member State in which the payment has its source shall be followed by the other Member State.*

#### 3.1 Background

##### 3.1.1 Combating Aggressive Tax Planning

While both economic and juridical double taxation is claimed to be unfair from a taxpayer's perspective, double non-taxation is regarded as unfair, immoral and often also as illegal from the viewpoint of the society.<sup>35</sup> However, it has to be clearly differentiated between illegal tax evasion through direct violation of a tax provision and

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Eberhartinger and Six, 'Taxation of Cross-Border Hybrid Finance: A Legal Analysis', (supra n. 21), p. 4 et seq.

<sup>32</sup> 'Anti Tax Avoidance Package', (supra n. 10).

<sup>33</sup> Explanatory Memorandum to COM(2016) 26 final, (supra n. 11), p. 1.

<sup>34</sup> It must be pointed out that Art. 10 in the current version of the ATAD changed compared to the version of the 28<sup>th</sup> of January 2016 on which this thesis is based. The new wording is as follows: (1) To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source. (2) To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment. The changed wording does however not affect the overall question which is relevant for the analysis in this thesis. See for the most recent draft of the ATAD: 'Updated Draft on the Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market – Presidency compromise, 9431/16, FISC 83, ECOFIN 498, 24. May 2016' (2016) <http://data.consilium.europa.eu/doc/document/ST-9431-2016-INIT/en/pdf> accessed 31. May 2016.

<sup>35</sup> Anne Van de Vijver, 'International Double (Non-)taxation: Comparative Guidance from European Legal Principles' [2015] EC Tax Review, p. 240; Helminen, 'EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements', (supra n. 22); Pascal Saint-Amans and Raffaele Russo, 'The BEPS Package: Promise Kept' [2016] Bulletin for International Taxation, p. 236.

legal tax planning.<sup>36</sup> EU citizens may benefit from the different tax systems in other Member States. They are free to choose the country which is the most beneficial for their activities.<sup>37</sup> However, it was also put forward that such tax planning must certainly have its limits. Double non-taxation is capable to be harmful for the EU, its Member States and their citizens as it causes a worldwide loss of tax revenue, the distortion of competition, negative impact economic efficiency as well as a lack of transparency and fairness.<sup>38</sup> As these effects have been considered to be harmful for the aim to establish an internal market, efforts have been made to neutralize them somehow.<sup>39</sup> Nonetheless, the initiatives to limit the tax-panning possibilities of EU nationals, whether in form of domestic or secondary legislation, must not contravene with the target pursued to establish an internal market without any obstacles to the free movement of goods, persons, services and capital as well as with the sovereignty of the Member States. Therefore, a conflict arises between the sovereignty of the EU Member States to implement their own tax system, the aim to establish an internal market without any obstacles for taxpayers and the need to prevent the harmful effects caused by extensive double non-taxation.<sup>40</sup>

The tax planning possibilities created through hybrid mismatch arrangements were recently addressed by the BEPS report on Action 2 as well as by the amendments of the PSD. Some insights were given on how the harmful effects of such arrangements could be neutralized. Therefore, they will be shortly described in the following chapters.

### **3.1.2 BEPS Action 2 on Hybrid Mismatch Arrangements**

On the 5<sup>th</sup> October 2015 the OECD published its final BEPS report. The report on Action 2 regarding the neutralization of hybrid mismatch arrangements includes recommendations regarding the design of domestic rules to neutralize the effects of hybrid instruments and entities (Part I) and the development of model treaty provisions (Part II). The report aims to target double-deduction (DD) as well as deduction/no-inclusion (D/NI) outcomes triggered by arrangements which rely on hybrid element in order to produce such outcomes by exploiting the differences of the tax systems of two States.<sup>41</sup> Regarding the changes of the domestic law the OECD recommends the adoption of so-called linking rules which shall align the tax treatment of an instrument or entity with the tax treatment in the counterparty jurisdiction. Otherwise, they do not disturb the commercial outcomes.<sup>42</sup> In detail this means that, on the one hand, the jurisdiction of the paying company shall deny the deduction of interest expenses if the jurisdiction of the recipient does not include the corresponding income in the taxable

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<sup>36</sup> See Russo, *Fundamentals of International Tax Planning*, (*supra* n. 4), p. 49 et seq.

<sup>37</sup> CJEU, 9. March 1999, C-212/97, *Centros*, ECR [1999] I-1459, para. 27.

<sup>38</sup> Helminen, 'EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements', (*supra* n. 22), p. 327.

<sup>39</sup> See Ch. 3.1.2 and Ch. 3.1.3.

<sup>40</sup> Wolfgang Schön, 'Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?' [2015] *Bulletin for International Taxation*, p. 271.

<sup>41</sup> OECD, *OECD/G20 BEPS Project: Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, p. 17 et seq.

<sup>42</sup> *Ibid.*, p. 11.

base of the receiving company (primary rule).<sup>43</sup> On the other hand, the jurisdiction of the recipient company shall deny the exemption of income from the taxable base if the source jurisdiction allowed the deduction at the level of the payer company (defensive rule).<sup>44</sup> The OECD recommendations would only apply to hybrid financial instruments between related parties whereby a direct or indirect ownership of 25% by vote or value is the threshold.<sup>45</sup>

As the OECD has no legislative power, every State can implement these rules independently. Therefore – and particularly with regard to the fact that most of the EU Member States are, at the same time, members of the OECD – doubts were expressed that a non-uniform implementation would lead to new loopholes and would additionally have adverse effects on the internal market within EU.

### 3.1.3 Amendments to the Parent-Subsidiary Directive

As a reaction to the OECD BEPS project, two Council directives recently amended the PSD. The first amendment, which is of major importance for the purpose of this thesis, took place in 2014. It concerned Art. 4 of the PSD and introduced a rule which aims to tackle hybrid mismatch arrangements.<sup>46</sup> According to the new wording of Art. 4.1(a) the tax exemption of dividend income in the Resident State of the parent company shall only take place *to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary*. This linking rule ties up to the defensive rule recommended in BEPS Action 2. Art. 4.1(a) authorises the Member State of the parent company to align the domestic tax treatment of a received profit distribution in accordance with the tax treatment by the Source State of the same payment. In other words, the parent company is obliged to check whether the profit distribution in question was deducted as business expense on the level of the distributing company. If this is not the case, the received income must be included in the taxable base of the parent company. However, some doubts were already raised with regard to the consistency of this linking rule with primary law.<sup>47</sup>

The second change to the PSD – which shall be of minor interest for the following considerations – took place in 2015 and introduced a new, broader GAAR in Art. 1(2).<sup>48</sup> Now, Member States shall not grant the benefits of the PSD not only in case of fraud and abuse but also in cases of arrangement which have the main purpose, or

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<sup>43</sup> *Ibid.*, p. 17.

<sup>44</sup> *Ibid.*

<sup>45</sup> *Ibid.*, p. 24 and for the definition of the term related company see p. 113.

<sup>46</sup> Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU, OJ L 219/40.

<sup>47</sup> Cecile Brokelind, 'Legal Issues in Respect of the Changes to the Parent- Subsidiary Directive as a Follow-Up of the BEPS Project' [2015] Vol. 43, Intertax, p. 816, 818 and 821 et seq; Romero J.S.Tavares and Bret N. Bogenschneider, 'The New De Minimis Anti-abuse Rule in the Parent-Subsidiary Directive: Validating EU Tax Competition and Corporate Tax Avoidance?' [2015] Vol. 43, Intertax, p. 484. For considerations regarding hybrid financial instruments and the PSD before the new linking rule was adopted see Eberhartinger and Six, 'Taxation of Cross-Border Hybrid Finance: A Legal Analysis', (*supra* n. 21), p. 13 et seq.

<sup>48</sup> Council Directive (EU) 2015/121 of 27 January 2015 amending Directive 2011/96/EU, OJ L 21/1.

one of the main purposes, of obtaining a tax advantage that defeats the object or purpose of the PSD and that are not genuine.<sup>49</sup>

### 3.2 Adoption of Secondary Legislation

The EU institutions may adopt legal acts in order to promote harmonization in a certain field of law (positive integration). With regard to the ATAD a legal basis can be found in Art. 115 TFEU. Accordingly, the Council is authorised to issue directives in order to approximate laws, regulations or administrative provisions that are directly affecting the establishment or the functioning of the internal market. The competence to adopt secondary legislation must however be seen in the light of the limits set to it by the principle of conferral. Accordingly, the EU shall act only within the limits of the competences conferred upon it by the Member States.<sup>50</sup> In exercising such competences, the institutions shall moreover act only within the limits of the principles of subsidiarity and proportionality.<sup>51</sup> It might be interesting to note at this point that the Swedish as well as the Maltese government find the compliance with principles of subsidiarity and proportionality as not fulfilled in the case of the ATAD.<sup>52</sup> As the requirement of unanimity must be fulfilled it remains to be seen whether the directive is going to be adopted or not.

If however adopted, the EU Member States are directly bound by the provisions set out by the directive and are therefore obliged to adjust their domestic legislation in order to comply with it.<sup>53</sup> A directive is only binding as to the result to be achieved but leaves it to the Member States to choose the form and method of implementation.<sup>54</sup> Because of this discretion, differences among the Member States' tax systems are the unavoidable consequence. Additionally, there is a considerable risk of wrong implementation into national law. For this reason, the CJEU is the competent authority to interpret domestic law provisions in the light of their compatibility with the directive and EU law in general. In the field of direct taxation the fundamental freedoms of the TFEU as interpreted by the CJEU (negative integration) have turned out to be the most important legal basis.<sup>55</sup>

As there is a particular hierarchy of the EU sources of law – on the top of which are the constituent treaties<sup>56</sup> as well as the general principles of law (so-called primary EU law) – secondary legislation itself must be in consistency with the sources of law which have

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<sup>49</sup> See also in this regard Brokelind, 'Legal Issues in Respect of the Changes to the Parent- Subsidiary Directive as a Follow-Up of the BEPS Project', (*supra* n. 47).

<sup>50</sup> See Art. 4 and Art. 5 TEU.

<sup>51</sup> Art. 5(1) TEU.

<sup>52</sup> See for the current status and the objections of the Member States 'IPEX Platform for EU Interparliamentary Exchange on the Directive Proposal COM/2016/0026' <http://www.ipex.eu/IPEXL-WEB/dossier/document/COM20160026.do> accessed 15. May 2016.

<sup>53</sup> A Directive cannot itself impose any obligation on individuals. Furthermore, Member States cannot per se rely on a Directive against individuals. See CJEU, 5. July 2007, C-321/05, *Kofoed*, ECR [2007] I-5795, para. 42 and the case law cited there. However, under certain circumstances individuals may directly rely on a directive. This requires that the provisions of a directive are sufficiently precise, clear and unconditional and that the time limit for implementation has elapsed, see CJEU, 19. Jan. 1982, 8/81, *Becker*, ECR [1982] 53, para. 25.

<sup>54</sup> Art. 288 TFEU.

<sup>55</sup> Adamczyk, 'The Sources of EU Law Relevant for Direct Taxation', (*supra* n. 20), p. 25.

<sup>56</sup> TEU and TFEU.

precedence over it.<sup>57</sup> In order to interpret the validity of such secondary legislation with primary EU law the CJEU is again the competent authority.<sup>58</sup> Consequently, in order to analyse whether Art. 10 ATAD, in particular as regards hybrid financial instruments, is in line with primary law, the provision must be scrutinized in the light of the general principles and the fundamental freedoms as interpreted by the CJEU by way of negative integration.

### 3.3 Applicability and Scope

The overall objective of the ATAD shall be to target tax avoidance practices that are capable to distort the establishment and the functioning of the internal market.<sup>59</sup> Such tax avoidance practices involve situations where taxpayers act against the actual purpose of the law and taking advantage of the existing disparities between the national tax systems of the Member States in order to reduce their tax bill.<sup>60</sup> The European Commission stressed the need for common strategic approaches and coordinated actions in order to improve the functioning of the internal market and to maximize the positive effects that the BEPS initiative could have. The absence of coordinated actions could lead to a fragmentation of the market and could create new tax loopholes.<sup>61</sup>

Pursuant to Art. 1, the ATAD aims to cover all taxpayers that are subject to corporate tax in a Member State of the EU. Additionally, the subjective scope of the directive embraces permanent establishments situated in the EU even if the corporate taxpayers to which they belong are not themselves situated within the EU and therefore, not subject to the directive. The directive, however, obviously excludes partnerships from its scope which could lead several situations in which the applicability of the directive is in question.<sup>62</sup> Furthermore, no specific definition of the term permanent establishment is provided so that it is not clear whether the national definitions are at stake or rather internationally accepted standards.<sup>63</sup> The provision on hybrid financial instruments shall apply to all arrangements without requiring any participation or ownership structure.<sup>64</sup>

Art. 3 explicitly stresses that the ATAD introduces a minimum level of protection and that Member States are not precluded to introduce domestic provisions which aim to safeguard a higher level of protection. Accordingly, the ATAD collides with its own

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<sup>57</sup> See in detail to the hierarchy of the legal sources of EU law Paul Craig and Gráinne de Búrca, *EU Law - Text, Cases, and Materials* (5th edn, Oxford University Press 2011), p. 103 et seq. See also Rosa Raffaelli, 'Sources and scope of European Union law' (*European Parliament*, 01.10.2015) [http://www.europarl.europa.eu/ftu/pdf/en/FTU\\_1.2.1.pdf](http://www.europarl.europa.eu/ftu/pdf/en/FTU_1.2.1.pdf) accessed 10. May 2016.

<sup>58</sup> Art. 19(3) TEU.

<sup>59</sup> Explanatory Memorandum to COM(2016) 26 final, (*supra* n. 11), p. 3.

<sup>60</sup> *Ibid.*

<sup>61</sup> COM(2016) 26 final, (*supra* n. 11), recital (2).

<sup>62</sup> See further Jochen Lüdicke and Florian Oppel, 'Kommissions-Entwurf einer Anti-BEPS-Richtlinie: Grundlegende Änderungen und Verschärfungen des deutschen Rechts' [2016] *Der Betrieb*, p. 549; Claus Jochimsen and Tim Zinowsky, 'BEPS: BEPS und der Weg der Europäischen Union – Anmerkungen zum ersten Entwurf einer europäischen Richtlinie gegen Steuervermeidungsansätze' [2016] *ISR*, p. 106, 108 et seq.

<sup>63</sup> A clear definition of this term is also not included in the most recent draft of the ATAD, see *supra* n. 34.

<sup>64</sup> This is different in the case of the interest limitation rule (Art. 4) and the CFC rules (Art. 8). The updated draft of the ATAD (*supra* n. 34) contains further statements in this regard. See also Ch. 3.4.

overall aim, namely to establish coordinated actions and coherence within the internal market.<sup>65</sup> Member States are allowed to introduce deviating rules which can be more far reaching as what is proposed by the ATAD. As a consequence, the compatibility of these domestic provisions with primary EU law could be questioned in 28 cases. This appears highly problematic in the light of the principle of legal certainty.

Finally, with regard to hybrid financial instruments the directive aims to cover situation in which a different legal characterisation of the same payment by two sovereign jurisdictions leads to DD or D/NI outcomes. The Residence State of the recipient of the payment is put in the situation to avoid double non-taxation by following the legal characterization given to the payment by the Source State. The scope of this provision is aimed to be limited on intra-EU situation without including situations with third countries.<sup>66</sup>

On a closer look it becomes evident that the concept used by the ATAD is different from those of BEPS Action 2 and the PSD. The linking rules recommended by the OECD require that the jurisdictions included review the tax treatment in the counterparty jurisdiction and thereupon, based on the particular treatment, deny the deduction of expenses in the Source State (primary rule) or deny the exemption of certain income at the level of the recipient (defensive rule). The provision amended in the PSD capitalizes on the latter and provides for a refusal of the benefits of the directive if the profit distribution is considered to be a deductible expense in the Source State. Therefore, the PSD linking rule does not re-characterize a hybrid financial instrument from debt to equity.<sup>67</sup> However, such re-characterization, as is can be found in the case of thin-cap rules, is now proposed by the draft of the ATAD according to which the jurisdiction of the receiving company shall follow the legal characterization that is given to the particular instrument by the jurisdiction of the payer. This can lead to a situation where a tax-exempt dividend in the Resident State is re-qualified into interest income which is, however, subject to tax. In other words, the benefit of dividend income being tax exempt is denied based on the sole qualification of a financial transaction in the Source State. The following figure illustrates possible cross-border situation in which one Source State (A) would characterize a payment as debt while another Source State (B) would qualify the same kind of payment as equity. While the receiving company is subject to the same tax treatment as regards the purely domestic payments and the payment received from Source State B, the tax treatment with regard to the payment received from Source State A would differ.

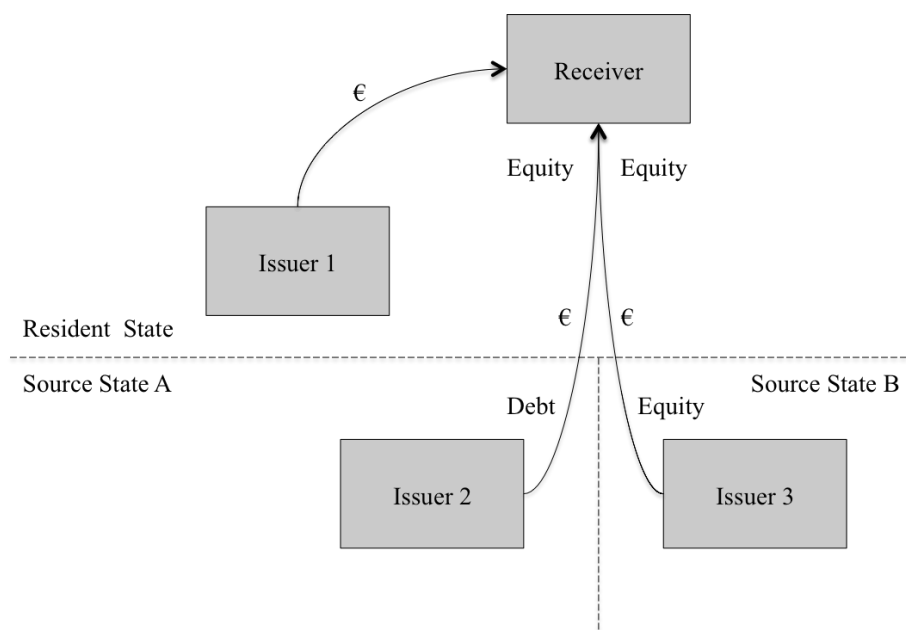
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<sup>65</sup> Jochimsen and Zinowsky, 'BEPS: BEPS und der Weg der Europäischen Union – Anmerkungen zum ersten Entwurf einer europäischen Richtlinie gegen Steuervermeidungsansätze', (*supra* n. 62), p. 109; Lüdicke and Oppel, 'Kommissions-Entwurf einer Anti-BEPS-Richtlinie: Grundlegende Änderungen und Verschärfungen des deutschen Rechts', (*supra* n. 62), p. 550.

<sup>66</sup> COM(2016) 26 final, (*supra* n. 11), recital (11).

<sup>67</sup> Brokelind, 'Legal Issues in Respect of the Changes to the Parent- Subsidiary Directive as a Follow-Up of the BEPS Project', (*supra* n. 47), p. 818.





Furthermore, it is not clear how this re-characterization would influence the subsequent tax treatment of the recipient company in its resident Member State.<sup>68</sup> A logical, further reaching consequence of the re-characterization of dividend income into interest income could in particular affect the national interest deduction limitation rules. If treating the payment as interest income would be compulsory for all subsequent tax assessments of the receiving company, the same treatment would also have to be considered with a view to the national interest deduction limitation rules.<sup>69</sup> The interest income would, at the same time, raise the amount of interest expenses which could be deducted for tax purposes.

### 3.4 Interaction with the Parent-Subsidiary Directive

As it has been demonstrated, the measure proposed in Art. 10 of the ATAD may cause further questions compared to the particular BEPS recommendations on hybrid mismatch arrangements and the corresponding amendments of the PSD. It is not clear up to this date which concept will be used in the final version of the ATAD, if even adopted. Most recently, on the 25<sup>th</sup> May 2016, the ECOFIN discussed the current version of the ATAD but could, however, not reach a common consensus on the draft.<sup>70</sup>

Since the Member States of the EU are obliged to implement the recent amendments to the PSD, which do also concern the neutralization of hybrid mismatch arrangements, the question arises how both legal sources would interact with each other. The ATAD,

<sup>68</sup> With regard to the linking of legal qualifications of hybrid entities see Arne Schnitger, 'Hybrid Mismatches' in Andreas Oestreicher (ed), *BEPS - Base Erosion and Profit Shifting* (NWB 2015), p. 20 et seq.

<sup>69</sup> Sebastian Benz and Juliane Böhmer, 'Das Anti Tax Avoidance Package (ATA-Paket) der EU-Kommission zur Umsetzung der BEPS-Maßnahmen in der EU' [2016] *Der Betrieb*, p. 307, 312.

<sup>70</sup> See for more information and the entire debate during the meeting ECOFIN, 'Economic and Financial Affairs Council meeting - Anti tax avoidance directive' (*European Council, Council of the European Union*, 25. May 2016) <http://www.consilium.europa.eu/en/policies/anti-tax-avoidance-package/>, accessed 31. May 2016.

in the version as of the 28<sup>th</sup> January 2016, does not require any participation relationship between the companies involved for the provision on hybrid financial instruments to be applicable. This would lead to the assumption that the linking rule introduced in the PSD is at stake in the case of associated companies, provided that the parent company holds at least 10% of the shares of the subsidiary.<sup>71</sup> In all other cases, the ATAD would be applicable.

It must however be pointed out that, in the meanwhile, the ATAD proposal changed due to the on-going negotiations on this draft.<sup>72</sup> Art. 2 ATAD, which provides for general definitions on certain terms, now also includes a definition on the term ‘associated enterprise’ according to which a shareholding of 25% or more is regarded as a qualified participation for the purpose of the ATAD.<sup>73</sup> Furthermore, in the new Art. 2(8) ATAD, an attempt of defining the term ‘hybrid mismatch’ is made. Accordingly, a “[...] *‘hybrid mismatch’ means a situation between a taxpayer in one Member State and an associated enterprise in another Member State or a structured arrangement between parties in Member States [...]*”, if this situation leads to either a DD outcome or a D/NI outcome. It remains to be seen whether, and to what extent, the scope of the ATAD will collide with the scope of the PSD. In any case, whenever associated companies with a shareholding of at least 10% are concerned, the ATAD would overlap with the PSD and should, therefore, not have a scope of application.<sup>74</sup>

Alongside the specific questions that might be raised by the ATAD, the overall target pursued by rules that aim to neutralize the adverse effects of hybrid financial instruments is, in any case, to align the tax treatment of such instruments in one jurisdiction to the tax treatment in another jurisdiction. In other words, they aim to achieve a symmetrical tax treatment of cross-border transactions. No matter which concept will be used in the final version of the ATAD, the question also remains with regard to the PSD amendments to what extent domestic law can make the tax treatment of a particular situation dependent of the tax treatment in another State.<sup>75</sup> If this symmetry leads to a differential tax treatment of purely domestic and cross-border situation, it appears doubtful whether such rules are compatible with EU law. To address this general question will be the aim of the following analyses.

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<sup>71</sup> Art. 3 PSD.

<sup>72</sup> ‘Updated Draft on the Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market – Presidency compromise, 9431/16, FISC 83, ECOFIN 498, 24. May 2016’

<sup>73</sup> Art. 2(3) ATAD.

<sup>74</sup> From a Luxembourgian perspective see Oliver R. Hoor, Keith O’Donnell and Samantha Schmitz-Merle, ‘EU Commission Releases Draft Directive on BEPS: A Critical Analysis from a Luxembourg Perspective’ [2016] Vol. 56 European Taxation, p. 192, 196.

<sup>75</sup> With regard to the British CFC legislation it was seen that, under certain circumstances, a Member State could make its national tax treatment depended on what is happening in another State. Such legislation must however meet specific preconditions (see in this regard Ch. 4.4.3).

## 4 Compatibility Analysis

### 4.1 Introduction

As already mentioned in chapter 3.1.1, there is a fundamental conflict between the goal to establish the unhindered functioning of the internal market, on the one hand, and the integrity of Member States on the other. The internal market shall provide for the free movement of goods, services, persons and capital without exerting any influence on the decisions of EU nationals (principle of neutrality).<sup>76</sup> On the contrary, direct taxation is not harmonized within the EU which leads to the Member States remaining competent in this field of law. They are sovereign in determining the basis on which they tax persons and income in a given geographical territory (territoriality principle).<sup>77</sup> However, in examining these competences, Member States must comply with EU law.<sup>78</sup>

To give guidance on how these two fundamental principles set limits to one another is the endeavour of the CJEU. In examining whether a specific provision implemented by a sovereign Member State is compatible with primary EU law the CJEU developed a specific procedure consisting out of three distinct steps. First of all, the Court examines which of the fundamental freedoms is applicable in the particular case. It continues with its discrimination or restriction analysis in establishing whether there is a different treatment of two comparable situations or whether there is a measure which hinders the exercise of the fundamental freedoms or makes it less attractive. If a discrimination or restriction can be identified, the CJEU evaluates in a final step whether the restriction can be justified by overriding reasons of public interest and whether the measure used is not exceeding what would be considered necessary to achieve the goal intended. The subsequent analysis will follow these steps in order to evaluate the compatibility of linking rules with primary EU law in the light of the case law of the CJEU.

### 4.2 Applicable Freedom(s)

With regard to hybrid financial instruments the freedom of establishment<sup>79</sup> as well as the free movement of capital<sup>80</sup> appear to be the most relevant legal basis.<sup>81</sup> Determining the suitable fundamental freedom that is at stake in a specific situation is of particular importance as the coverage of the freedoms differs.

Art. 49 TFEU prohibits restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State. This includes restrictions on the setting-up of agencies, branches or subsidiaries. The place of the registered office of a company has the same meaning as nationality for individual taxpayers.<sup>82</sup> For the freedom of establishment to be applicable the so-called ‘control test’, which was

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<sup>76</sup> Schön, 'Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?', (*supra* n. 40), p. 272.

<sup>77</sup> *Ibid.*, p. 280.

<sup>78</sup> *Schumacker*, C-279/93, (*supra* n. 2), para. 21.

<sup>79</sup> Art. 49 TFEU.

<sup>80</sup> Art. 63 TFEU.

<sup>81</sup> The freedom to provide services and the free movement of goods are not suitable for the case at hand.

<sup>82</sup> See inter alia CJEU, 28. January 1986, 270/83, *Commission vs. France (Avoir Fiscal)*, ECR [1983] 285, para. 18.

established in *Baars*, must be fulfilled.<sup>83</sup> According to the reasoning in that case, which has been confirmed by the Court later on,<sup>84</sup> the freedom of establishment is exercised whenever a national of a Member State holds qualified participation in the capital of a company established in another Member State which enables a definite influence over the company's decisions.

According to Art. 63 TFEU, all restrictions on the movement of capital and payments between Member States and between Member States and third countries shall be prohibited.<sup>85</sup> While the freedom of establishment only covers situations between two Member States, the free movement of capital is also applicable in third country situations. This includes all measures that "[...] are liable to dissuade its residents from obtaining loans or making investments in other Member States [...]."<sup>86</sup>

The CJEU gave an order of priority to these two freedoms. Accordingly, the applicability of the freedom of establishment prevails over the free movement of capital if the discriminatory effects under Art. 63 are simply an „*unavoidable consequence*“ of the discrimination of Art. 49.<sup>87</sup> Whenever there is no such qualified participation, however, the free movement of capital would be applicable. The ATAD proposal in its current state of work does not require the participation by one company in the capital of another company<sup>88</sup> whereas, on the contrary, the PSD requires a shareholding of at least 10%.<sup>89</sup> As the ATAD shall therefore not only cover arrangements between related parties makes the free movement of capital particularly interesting in this regard. Depending on whether a situation, which is subjectively and objectively covered by the scope of the directive, occurs between two unrelated or related companies, either the free movement of capital or the freedom of establishment applies. The free movement of capital would extend the effect of a particular decision towards third countries which should, however, not be covered by the ATAD. As the ATAD in its current version does not require a certain participation relationship between the companies, it is likely that this conflict arises.

Furthermore, it must be stressed that linking rules will affect the tax treatment of a company by its State of resident. In accordance with the wording of the freedom provisions only restrictions or discrimination by the host State are prohibited. However, the CJEU has consistently held that also the home State is prohibited from hindering its own nationals from exercising their rights of free movement.<sup>90</sup>

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<sup>83</sup> CJEU, 13. April 2000, C-251/98, *Baars*, ECR [2000] I-2787, para. 22.

<sup>84</sup> See inter alia CJEU, 12. Sep. 2006, C-196/04, *Cadbury Schweppes*, ECR [2006] I-7995, para. 31; CJEU, 13. March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation* ECR [2007] I-2107, para. 27.

<sup>85</sup> Regarding the notion of capital see Art. 1 and Annex I of the Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, OJ L 178/5.

<sup>86</sup> CJEU, 1. July 2010, C-233/09, *Dijkman and Dijkman-Lavaleije*, ECR [2010] I-6649, para. 25 and the case law cited there.

<sup>87</sup> CJEU, 10. May 2007, C-492/04, *Lasertec*, ECR [2007] I-3775, para. 25.

<sup>88</sup> See Ch. 3.3 and 3.4.

<sup>89</sup> See Art. 3 PSD.

<sup>90</sup> See inter alia CJEU, 29. Nov. 2011, C-371/10, *National Grid Indus*, ECR [2011] I-12273, para. 32.

## 4.3 Discrimination and Comparability

### 4.3.1 Discrimination or Restriction

According to the fundamental principle of equality, all nationals of the EU who find themselves in the same situation shall enjoy the same legal treatment irrespective of their nationality.<sup>91</sup> Hence, Art. 18 TFEU, as *lex generalis*, takes this principle into account by generally prohibiting any kind of discrimination on grounds of nationality. Additionally, the principle of non-discrimination is inherent in each of the more specific fundamental freedoms<sup>92</sup> which prevail over this general provision. According to the CJEU's understanding of this principle, discrimination arises "*only through the application of different rules to comparable situations or the application of the same rule to different situations.*"<sup>93</sup> In the course of this general definition of discrimination not only direct discrimination on grounds of nationality but also covert or indirect discrimination based on other criteria of differentiation, such as residence, are prohibited.<sup>94</sup>

Moreover, the fundamental freedoms prohibit restrictions which do not constitute direct discrimination on grounds of nationality or residence.<sup>95</sup> The idea of a restriction is somewhat different as it covers rather obstacles and impediments of the internal market which are liable to make cross-border situations less attractive.<sup>96</sup> Some scholars additionally support the argument that the restriction test does not necessarily require a comparable situation but that it is rather an absolute, independent concept.<sup>97</sup> It is, however, not clear and therefore debated whether the concept of a restriction is different from that of discrimination for direct tax purposes. With a view to the CJEU's recent case law a sharp distinction may hardly be of any relevance.<sup>98</sup> Hence, for the purpose of this thesis this discussion shall not be entered.

Admittedly, it is unlikely that linking rules will cause a direct discrimination since they do not necessarily distinguish between the nationalities of taxpayers. They will rather make the granting of certain tax benefits depended from the tax treatment at the level of the debtor without distinguishing between domestic and cross-border situations. Nonetheless, given that qualification conflicts of financial instruments only arise because of a different legal qualification by two sovereign Member States, such rules

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<sup>91</sup> Marjaana Helminen, *EU Tax Law – Direct Taxation 2015* (IBFD 2015), p. 57.

<sup>92</sup> Namely, the free movement of goods, services, persons and capital.

<sup>93</sup> *Schumacker*, C-279/93, (*supra* n. 2), para. 30.

<sup>94</sup> CJEU, 8. May 1990, C-175/88, *Biehl*, ECR [1990] I-1779, para. 13; Ben J. M. Terra and Peter J. Wattel, *European Tax Law* (6th edn, Kluwer Law International 2012), p. 54.

<sup>95</sup> Helminen, *EU Tax Law – Direct Taxation 2015*, (*supra* n. 91), p. 65.

<sup>96</sup> Jakob Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 1' [2013] Vol. 53, *European Taxation*, p. 539, 549; Terra and Wattel, *European Tax Law*, (*supra* n. 94), p. 57.

<sup>97</sup> Niels Bammens, *The Principle of Non-Discrimination in International and European Tax Law* (IBFD Doctoral Series, Vol. 24, 2013), p. 536; Vanessa E. Englmaier, 'The Relevance of the Fundamental Freedoms for Direct Taxation' in Michael Lang and others (eds), *Introduction to European Tax Law on Direct Taxation* (3rd edn, Linde 2013), p. 56.

<sup>98</sup> Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 1', (*supra* n. 96), p. 550; Englmaier, 'The Relevance of the Fundamental Freedoms for Direct Taxation', (*supra* n. 97), p. 57.

will never truly apply to purely domestic situations.<sup>99</sup> As a consequence, such rules are capable to make cross-border situations less attractive compared to purely domestic situations.

### 4.3.2 Comparability

The comparability analysis is often referred to as the key element of the CJEU's discrimination analyses.<sup>100</sup> Only if a situation is objectively comparable to another situation, the question of whether there is a discrimination or restriction can be answered. In its well-established case law the CJEU consistently repeats that residents and non-residents are not, as a rule, comparable unless there are good reasons to assume comparability.<sup>101</sup> It is anything but easy to find a 'red line' in the CJEU's case law regarding the approach chosen to establish the most appropriate pair of comparison. In fact, the opposite is true as it becomes evident that the Court is not consistent at all in its way to establish whether or not two situations are comparable.<sup>102</sup> Because of this inconsistency it appears difficult to predict which comparator the CJEU would choose in the case of hybrid mismatch arrangements. However, some guidance might nonetheless be identified. As the choice of the pair of comparison might have a great impact on the outcome of the restriction analyses, a more detailed consideration become necessary.

First of all, it will be discussed whether a classic, vertical comparison or a horizontal pair of comparison can be established. Secondly, and to a greater extent, the question of 'how' and to 'what extent' the situation of a taxpayer is taken into account will be addressed. Depending on whether a comparison only takes into account the tax treatment of a single taxpayer on a stand-alone basis (per-country-approach) or the tax situation of a group of companies as a whole (overall approach), the outcome may differ fundamentally.<sup>103</sup>

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<sup>99</sup> See OECD, *OECD/G20 BEPS Project: Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, according to which hybrid mismatches are a cross-border phenomenon.

<sup>100</sup> Michael Lang, 'Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions' [2009] *EC Tax Review*, p. 98; Bammens, *The Principle of Non-Discrimination in International and European Tax Law*, (*supra* n. 97), p. 526; Jessica Di Maria, 'Comparability in the case of Hybrid Mismatch: In Search of an Approach Suitable for the Current European Landscape' in Michael Lang (ed), *Non-Discrimination in European and Tax Treaty Law - Open Issues and Recent Challenges* (Linde 2015), p. 63, 71.

<sup>101</sup> In this sense see *Schumacker*, C-279/93, (*supra* n. 2), para. 34.

<sup>102</sup> See for an comprehensive overview on the CJEU's case law regarding the comparable situation Lang, 'Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions', (*supra*, n. 100); Peter Wattel, 'Non-Discrimination à la Cour: The ECJ's (Lack of) Comparability Analysis in Direct Tax Cases' [2015] Vol. 55, *European Taxation*, p. 542.

<sup>103</sup> Di Maria, 'Comparability in the case of Hybrid Mismatch: In Search of an Approach Suitable for the Current European Landscape', (*supra* n. 100), p. 72.

#### 4.3.2.1 Vertical vs. Horizontal Comparability

The traditional pair of comparison is a vertical one.<sup>104</sup> This means that the CJEU compares a cross-border situation with a purely domestic situation. In the case of hybrid financial instruments a pair of comparison can be found between an investment made by a domestic company with a company established in another Member State and an investment made between two domestic companies.<sup>105</sup> Notwithstanding that the vertical comparison is most frequently used by the CJEU it is also conceivable that the Court would apply a horizontal comparison. With a view to the illustration in Ch. 3.3 it becomes evident that the same kind of financial instrument can be qualified differently by two different source jurisdictions. Whenever a taxpayer has, inter alia, an investment in Source State A and an investment in Source State B and both jurisdictions characterize the instrument differently, the re-characterization of the income received from Source State A would lead to a difference in treatment even though these two cross-border situations are not objectively different. This result is the same with regard to the denial of the dividend exemption provided for by Art. 4.1(a) PSD.

The CJEU did already make use of the horizontal comparison in several cases.<sup>106</sup> In *Cadbury Schweppes* the Court compared the situation of a resident company, which had a subsidiary in one Member State, to a situation where the subsidiary was established in another, low tax Member State and found that there was no objective difference between those two situations.<sup>107</sup> Additionally, and with regard to inbound dividends, the Court considered in its *A* judgement that a difference in treatment of inbound dividends received from a Member State compared to dividends received from a third State can cause restriction.<sup>108</sup>

It must be kept in mind that the acceptance of a horizontal comparison as described above might raise a new discussion about a legal basis for a most-favoured-nation (MFN) principle in EU law. In the *D.* case the Court rejected the idea of MFN treatment with regard to a specific DTC provision.<sup>109</sup> On the other hand, in its recent decision in *Sopora*, the Court again accepted a horizontal comparison, as there were only unilateral measures at issue.<sup>110</sup> Nonetheless, no matter which pair of comparison the CJEU would use, a difference in treatment can be found in any case.

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<sup>104</sup> Bammens, *The Principle of Non-Discrimination in International and European Tax Law*, (*supra* n. 97), p. 595.

<sup>105</sup> Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 1', (*supra* n. 96), p. 550.

<sup>106</sup> *Cadbury Schweppes*, C-196/04 (*supra* n. 84); CJEU, 18. Dec. 2007, C-101/05, *A*, ECR [2007] I-11568; CJEU, 24. Feb. 2015, C-512/13, *C.G. Sopora*, not yet published.

<sup>107</sup> *Cadbury Schweppes*, C-196/04, (*supra* n. 84), para. 45.

<sup>108</sup> *A*, C-101/05, (*supra* n. 106), para. 42.

<sup>109</sup> CJEU, 5. July 2005, C-376/03, *D.*, ECR [2005] I-5821. See also in this context and with regard to DTC provisions CJEU, 19. Nov. 2015, C-241/14, *Bukovansky*, not yet published.

<sup>110</sup> *C.G. Sopora*, C-512/13, (*supra* n. 106), para. 25 and 26. See further to the MFN discussion Axel Cordewener and Ekkehart Reimer, 'The Future of Most-Favoured-Nation Treatment in EC Tax Law – Did the ECJ Pull the Emergency Brake without Real Need? – Part 1 and Part 2' [2006] *European Taxation*, p. 239 and p. 291.

#### 4.3.2.2 *Per-Country Approach*

As a point of departure, one general statement made by the CJEU with regard to dividend taxation in the Residence State shall be put first. The Court held that “[...] *the freedoms of movement guaranteed by the Treaty preclude a Member State from treating foreign-sourced dividends less favourably than nationally-sourced dividends, unless such a difference in treatment concerns situations which are not objectively comparable or is justified by overriding reasons in the general interest.*”<sup>111</sup>

One could argue that a cross-border situation including a mismatch is not comparable to a situation without a mismatch. The fact that the Source State would allow a deduction at the level of the issuing company would prevent the payment from being subject to economic double taxation.<sup>112</sup> This argumentation would require the tax situation in the Source State to be taken into account by the Residence State. On the contrary, by using the per-country approach the CJEU mainly focuses on the particular tax situation of a taxpayer on a standalone basis in one jurisdiction. With regard to the denial of the dividend exemption in the Residence State, the application of this approach would leave the deviating tax treatment in the Source State of the payment disregarded. Even though it might be difficult to predict whether the CJEU would make use of this latter approach rather than of the overall approach, there are good arguments in favour of this assumption. The following considerations do not aim to be exhaustive but shall provide an overview on the case law in which the use of a unilateral assessment becomes very clear.

One of the earliest cases in which the CJEU explicitly used the per-country approach was the *Eurowings* case.<sup>113</sup> In that case the German trade tax was at issue and the fact, that there was a difference in treatment depending on whether a German national received a service from a service provider established in Germany or from a service provider established in another Member State. Since foreign companies are not subject to German trade tax, the taxable base of the German recipient of the service was increased in order to take into account the lower burden that the foreign service provider had to suffer in comparison with the German service provider. In essence, the CJEU stressed that the tax advantages in form of a lower tax rate in one Member State “[...] *cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State.*”<sup>114</sup> Therefore, the Court examined the German tax treatment in isolation from the tax advantage in the other Member State. What can be concluded from this and also from later case law<sup>115</sup> is that a Member State cannot deny certain tax benefits to its residents simply because they are established in another Member State in which they are subject to a certain tax treatment.

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<sup>111</sup> CJEU, 12. Dec. 2006, C-446/04, *Test Claimants in the FII Group Litigation*, ECR [2006] I-11753, para. 46.

<sup>112</sup> Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part I', (*supra* n. 96), p. 551.

<sup>113</sup> CJEU, 26. Oct. 1999, C-294/97, *Eurowings*, ECR [1999] I-7447.

<sup>114</sup> *Ibid.*, para. 44.

<sup>115</sup> CJEU, 21. Nov. 2002, C-436/00, *X and Y*, ECR [2002] I-10829, para. 44; CJEU, 12. Dec. 2002, C-324/00, *Lankhorst-Hohorst*, ECR [2002] I-11779, para. 37 and 38 where the Court put forward the same argument in the framework of the justification analysis.



Subsequently, and with regard to inbound dividend taxation, the CJEU held in *Lenz* that “[...] the level of the taxation of companies established outside Austrian territory cannot justify a refusal to grant those same financial advantages to persons receiving revenue from capital paid by those latter companies.”<sup>116</sup> As a consequence, the CJEU established that shareholders resident in one Member State receiving dividends from companies established in the same Member State are objectively comparable to shareholders receiving dividends from companies established in another Member State,<sup>117</sup> regardless of the level of taxation in the Source State of the dividend. The same was established in *Keller Holding*.<sup>118</sup> At issue was the German legislation according to which certain expenses, that had an immediate economic connection to the participation in a subsidiary and, therefore, to the dividend income received therefrom, were deductible only in purely domestic situations. The Court found that this tax treatment for foreign sourced dividends is less favourable and, therefore, restrictive.<sup>119</sup> In establishing whether domestic sourced and foreign sourced dividends were comparable the CJEU disregarded the fact that a foreign indirect subsidiary was not subject to corporate tax in Germany.<sup>120</sup> It is also noteworthy that the Court of Justice of the European Free Trade Association States (EFTA Court) ruled on the basis of the per-country approach in the case of outbound dividends in its *Fokus Bank* ruling.<sup>121</sup> The fact that resident shareholders are subject to tax in Norway while non-resident shareholders were not is not sufficient to prevent those two situations from being comparable.<sup>122</sup>

The assumption occurred that the CJEU would use the per-country approach concerning the tax treatment of dividends in the Source State, and the overall approach with respect to the treatment in the Residence State.<sup>123</sup> This statement is however not generally true. It was seen in *Lenz* as well as in *Keller Holding* that the CJEU makes use of the per-country approach also in the case of inbound dividends and therefore, disregards the level of taxation of the distributing subsidiary. Additionally, in *SGI*,<sup>124</sup> the CJEU made use of a unilateral assessment in order to scrutinize national tax legislation in the Residence State. Whenever a parent company granted non-arm’s lengths advantages to its subsidiary, Belgian law provided for an interest upward adjustment at the level of this subsidiary. However, in case that the subsidiary was a non-resident, the upward adjustment was made at the level of the parent company. AG *Kokott*<sup>125</sup> and the CJEU<sup>126</sup> did not share the view of the Belgian government that it is

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<sup>116</sup> CJEU, 15. July 2004, C-315/02, *Lenz*, ECR [2004] I-7063, para. 42.

<sup>117</sup> The Court came to the same conclusion in CJEU, 7. Sep. 2004, C-319/02, *Manninen*, ECR [2004] I-7477 which led however to an undesirable consequence (see 4.3.2.3).

<sup>118</sup> CJEU, 23. Feb. 2006, C-471/04, *Keller Holding*, ECR [2006] I-2107.

<sup>119</sup> *Ibid.*, para. 35.

<sup>120</sup> *Ibid.*, para. 36 and 43.

<sup>121</sup> EFTA Court of Justice, 23. Nov. 2004, E-1/04, *Fokus Bank ASA*, EFTA Ct Rep 11.

<sup>122</sup> *Ibid.*, para. 29.

<sup>123</sup> Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 1', (*supra* n. 96), p. 550; Michael Lang, 'ECJ case law on cross-border dividend taxation - recent developments' [2008] EC Tax Review, p. 67, 72.

<sup>124</sup> CJEU, 21. Jan. 2010, C-311/08, *Société de Gestion Industrielle (SGI)*, ECR [2010] I-487.

<sup>125</sup> Opinion of Advocate General Kokott, 10. Sep. 2009, C-311/08, *Société de Gestion Industrielle (SGI)*, ECR [2010] I-487, para. 45.

necessary to base the considerations on a global perspective. The Court pointed out the legal independence of both entities and stated that “[...] *the tax burden borne by the recipient company in a domestic situation cannot be likened to the taxation, in a cross-border situation, of the company granting the advantage in question.*”<sup>127</sup> The Court therefore rejected to view a group of companies as a whole.<sup>128</sup>

In all these cases the Court followed the same consideration, that is to say, whether a detrimental tax treatment exists for cross-border situations within a national tax system can only be established when concentrating on the respective tax burden for similar domestic activities without taking into account compensating effects in other Member States.<sup>129</sup> In applying this case law on linking rules and their aim to tackle hybrid financial instruments, the fact that the Source State allows for a deduction of the payment would be disregarded for the purpose of establishing a comparable situation. As the compensating effects in another Member State are not taken into account, a restrictive treatment caused by linking rules could be identified.

#### **4.3.2.3 Overall approach**

The overall approach, by contrast, focuses on the total tax position of the taxpayer and takes into account influencing factors in other jurisdictions and even of other taxpayers, for example the companies of a group in other jurisdictions. The overall approach is sometimes referred to as internal market approach.<sup>130</sup> This notion reflects the impression that the overall approach encourages the establishment of the internal market in guaranteeing tax neutrality in terms of taxation without any internal frontiers.<sup>131</sup> Even though this seems to be a desirable effect, the case law on this approach shows that taking into account of legal effects in other Member States can lead to inaccurate results.

The starting point of using the overall approach was the *Schumacker* case<sup>132</sup> where, in examining whether a taxpayer was discriminated in Germany by not being able to take into account its family circumstances, the treatment in its Residence State Belgium was taken into consideration. However, this fundamental decision was, and still is, subject to heavy criticism.<sup>133</sup> Requiring one Member State to grant tax advantages to non-resident simply depend on the tax system of another Member State heavily interferes with their sovereign tax policies. Insufficient respect would be paid to the Member

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<sup>126</sup> *Société de Gestion Industrielle (SGI)*, C-311/08, (*supra* n. 124), para. 51.

<sup>127</sup> *Ibid.*, para. 52.

<sup>128</sup> Di Maria, ‘Comparability in the case of Hybrid Mismatch: In Search of an Approach Suitable for the Current European Landscape’, (*supra* n. 103), p. 75.

<sup>129</sup> Joachim Englisch, ‘Taxation of Cross-Border Dividends and EC Fundamental Freedoms’ [2010] Vol. 38, *Intertax*, p. 197, 208.

<sup>130</sup> Lang, ‘ECJ case law on cross-border dividend taxation - recent developments’, (*supra* n. 123), p. 72.

<sup>131</sup> *Ibid.* See also Art. 26 (2) TFEU.

<sup>132</sup> *Schumacker*, C-279/93, (*supra* n. 2).

<sup>133</sup> Bammens, *The Principle of Non-Discrimination in International and European Tax Law*, (*supra* n. 97), p. 604; Peter J. Wattel, ‘Progressive Taxation of Non-Residents and Intra-EC Allocation of Personal Tax Allowances: Why Schumacker, Asscher, Gilly and Gschwind Do Not Suffice’ [2000] *European Taxation*, p. 210.

States right to limit its taxation rights.<sup>134</sup> This can also be seen in a number of cases where the use of the overall approach led to undesirable results. In *Bosal*, where a holding company established in the Netherlands applied for a deduction of interest expenses related to the financing of certain participations in domestic as well as in foreign subsidiaries. The Dutch tax authorities refused the deduction for expenses related to non-resident subsidiaries.<sup>135</sup> The CJEU found this Dutch legislation to be a restriction which could not be justified in the light of the principles of coherence or territoriality. It seems that the Court based its result on the argument that profits of the foreign subsidiary would have been taxed regardless whether the Netherlands had taken the costs into account or not.<sup>136</sup> What was however criticized here is that the Court obviously did not consider that the Netherlands had, in fact, no right to tax the income of the subsidiary. Therefore, refusing the deductibility of losses, which had an economic link to such foreign income, should have been justified in the light of the coherence of the Dutch tax system.<sup>137</sup>

With regard to inbound dividends similar results were observed in *Manninen*.<sup>138</sup> A natural person applied for a tax credit in Finland for dividends received from a Swedish company. While the corporate tax paid by companies established in Finland could be credited against the income tax due by the shareholder, such credit was not granted if a company established in another Member State distributed the dividend. Dividends from paid by Finnish companies are subject to corporate tax on the level of the distributing company. This is however not the case with foreign companies. Also in this case the CJEU found a unjustified restriction by taking into account that the non-resident distributing company was subject to corporate tax in the other Member State and, therefore, subject to economic double taxation. The same reasoning was also established earlier in *Verkooijen*<sup>139</sup> and later on in *Meilicke*.<sup>140</sup> According to that case law on inbound dividends it can be concluded, that the situation of resident shareholders receiving foreign sourced dividends would only be different if the Source Member State already eliminated the risk of economic double taxation.<sup>141</sup> What the CJEU did however not consider in *Manninen* was that it is completely logical that the Finnish imputation system only takes Finnish and not also foreign corporate tax into account.<sup>142</sup> Besides the purpose of the avoidance of economic double taxation, which is inherent in domestic imputation systems, such systems additionally aim to assure that distributed profits are taxed at the same level as other kind of income which is not

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<sup>134</sup> Dennis Weber, 'In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC' [2006] Vol. 34, Intertax, p. 585, 595 et seq.

<sup>135</sup> CJEU, 18. Sep. 2003, C-168/01, *Bosal*, ECR [2003] I-9409, para. 9 – 11.

<sup>136</sup> *Ibid.*, para. 15.

<sup>137</sup> Weber, 'In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC', (*supra* n. 134), p. 595.

<sup>138</sup> *Manninen*, C-319/02, (*supra* n. 117).

<sup>139</sup> CJEU, 6. June 2000, C-35/98, *Verkooijen*, ECR [2000] I-4113.

<sup>140</sup> CJEU, 6. March 2007, C-292/04, *Meilicke and Others*, ECR [2007] I-1835.

<sup>141</sup> See e.g. *Manninen*, C-319/02, (*supra* n. 117), para. 33; CJEU, 12. Dec. 2006, C-374/04, *ACT Group Litigation*, ECR [2006] I-11673, para. 56; *Meilicke and Others*, C-292/04, (*supra* n. 140), para. 24.

<sup>142</sup> Weber, 'In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC', (*supra* n. 134), p. 597.

subject to a two-level tax burden.<sup>143</sup> Without considering the latter aim and reducing the purpose of an imputation system solely on the avoidance of economic double taxation, the question remains if it is possible to demand Member States to take into account foreign tax burdens.<sup>144</sup>

Another example for the inaccuracy of the overall approach is the *Schempp* case.<sup>145</sup> Egon Schempp, a German national resident in Germany, after his divorce paid alimony to his former spouse who lived in Austria. He sought for the deduction of this payment from his taxable base in Germany. However, the deduction of such expenses was refused under German law on the basis that the corresponding income was not taxable in Austria. The Court established that an alimony paid to a German resident was not comparable to alimony paid to an Austrian resident and therefore, the different treatment did not infringe EU law.<sup>146</sup> Also this case was subject to heavy criticism since the Court failed to consider that the less favourable outcome Mr. Schempp suffered was indeed discriminatory and not the simple result of disparities between the tax systems of two Member States. In fact, the German tax provisions were not neutral as regards cross-border payments.<sup>147</sup>

Indeed, tax sovereignty may result in disadvantageous treatment due to the parallel exercise of different tax systems, so-called disparities. Such disparities are not assessable under the fundamental freedoms because, in doing otherwise, the sovereignty of Member States would be endangered.<sup>148</sup> It is convincingly argued that prohibited restrictions can only be the result of the tax system of one single Member State and not due to the interaction of more than one Member State.<sup>149</sup> However, in using the overall approach restrictions, which arise only in one Member State, may be hidden insofar as the other Member State is able to remove such discriminatory effects.<sup>150</sup> Most recently, AG Kokott in her opinion to the pending case *Masco Denmark and Damixa* convincingly argued in favour of the so-called autonomy principle.<sup>151</sup> She pointed out that tax disadvantageous resulting from the parallel exercise of two or more different tax systems do not result in discriminatory prohibited under

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<sup>143</sup> Englisch, 'Taxation of Cross-Border Dividends and EC Fundamental Freedoms', (*supra* n. 129), p. 203.

<sup>144</sup> *Ibid.*

<sup>145</sup> CJEU, 12. July 2005, C-403/03, *Schempp*, ECR [2005] I-6421.

<sup>146</sup> *Ibid.*, para. 32 – 36.

<sup>147</sup> Bammens, *The Principle of Non-Discrimination in International and European Tax Law*, (*supra* n. 97), p. 979 et seq.

<sup>148</sup> See María Cruz Barreiro Carril, 'National Tax Sovereignty and EC Fundamental Freedoms: The Impact of Tax Obstacles on the Internal Market' [2010] Vol. 38, *Intertax*, p. 105, 107; Weber, 'In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC', (*supra* n. 134), p. 602; Sjoerd Douma, 'The Three Ds of Direct Tax Jurisdiction: Disparity, Discrimination and Double Taxation' [2006] *European Taxation*, p. 522, 524.

<sup>149</sup> Weber, 'In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC', (*supra* n. 134), p. 602.

<sup>150</sup> Carril, 'National Tax Sovereignty and EC Fundamental Freedoms: The Impact of Tax Obstacles on the Internal Market', (*supra* n. 148), p. 110.

<sup>151</sup> Opinion of Advocate General Kokott, 12. May 2016, C-593/14, *Masco Denmark and Damixa*, not yet published.

EU law.<sup>152</sup> The domestic tax provisions of the Member States involved must be considered autonomously. To connect the granting of certain benefits to the tax treatment in another Member State and, as a result, make the national tax treatment dependent upon the tax treatment of another Member State would contradict with the principle of autonomy.<sup>153</sup>

Additionally, when taking into consideration the legal situation in another Member State, there is a danger that the CJEU will acquire a greater legislative influence on the Member States tax systems.<sup>154</sup> With regard to cross-border investments, for example, some Member States would appear more attractive than others which would lead to the latter being indirectly forced to adopt their tax systems to that of other States. However, this is exactly what undermines the Member States' sovereignty. The CJEU would put itself in the position of a tax legislator with regard to direct taxation which is a field of law that should not be harmonized by EU institutions.<sup>155</sup>

Therefore, using the per-country approach can be regarded as being more suitable for the current European landscape.<sup>156</sup> Becoming dependent on other Member States' tax systems would result in a heavy constraint on tax sovereignty which is something that governments are neither used to nor likely to enjoy.<sup>157</sup>

#### **4.3.2.4 Interim Result and a Plea for the Per-Country Approach**

In a nutshell, and with regard to linking rules, a statement made by *Weber* gets to the heart of the problem: “*the assumption of discrimination is nothing more than a consequence of the method used.*”<sup>158</sup> The outcome of the restriction analysis will be highly depended on the method used by the CJEU in order to establish a comparable situation. A classic vertical as well as a horizontal comparison can be drawn by the CJEU. Further, in applying the per-country approach the Court would simply focus on the tax treatment in the Residence State and the fact that the dividend exemption is denied for foreign-sourced dividends. It would disregard the tax treatment in the source jurisdiction. When using the overall approach, however, the CJEU would consider the tax treatment in the Source State in determining whether the denial of the tax exemption infringes EU law and would, most likely, find that there is no comparable situation and no discrimination or restriction since the tax treatment in the Source State would compensate this tax disadvantage in the Residence State. It was presented that such approach is not suitable for the current European landscape as it undermines the tax sovereignty of Member States in direct tax matters. Additionally, there are also arguments that even if the whole group tax burden is considered, a restriction could be

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<sup>152</sup> *Ibid.*, para. 20. She also draws a distinction to the *Manninen* case, where the discriminatory effect was solely caused by one single Member State, see para. 31.

<sup>153</sup> *Ibid.*, para. 27. See in particular n. 9 in the opinion.

<sup>154</sup> Lang, 'ECJ case law on cross-border dividend taxation - recent developments', (*supra* n. 123), p. 72.

<sup>155</sup> *Ibid.*

<sup>156</sup> Weber, 'In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC', (*supra* n. 149), p. 588.

<sup>157</sup> Graeme S. Cooper, 'Some Thoughts on the OECD's Recommendations on Hybrid Mismatches' [2015] *Bulletin for International Taxation*, p. 334, 346.

<sup>158</sup> Weber, 'In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC', (*supra* n. 149), p. 598.

found. So concludes *Bundgaard* that if the tax rate in the Source State is lower than the rate in the Member State of the parent company, the interest deduction is of less value than the dividend exemption.<sup>159</sup>

### 4.3.3 Is there a Requirement for Mutual Recognition in EU Tax Law?

It has been demonstrated that the pair of comparison chosen will have a great impact on the outcome of the restriction analysis. Having the previous consideration regarding the possible restriction in mind it appears to be important to recall the overall aim of linking rules provided for by the PSD and the ATAD, that is to say, preventing double non-taxation by means of aligning the legal characterization of a payment in the Residence State to that of the Source State. The same is true for the OECD BEPS project as it also follows the principle that every income shall be taxed once somewhere.<sup>160</sup> To achieve this, linking rules build on the principle of mutual recognition.

The principle of mutual recognition is not a stranger to EU law. The TFEU explicitly refers to it as regards diplomas, certificates and other evidence of formal qualifications as well as for the coordination of the provisions laid down by law and regulation or administrative action in Member States.<sup>161</sup> EU law further refers to mutual recognition as regards security matters and the cooperation between police and judicial authorities,<sup>162</sup> judgements and judicial decisions.<sup>163</sup> Additionally, there are also some references in the CJEU's non-tax case law which give an impression on how legal mutual recognition could work. One example for that is the judgement in *Inspire Art*. The case concerned a UK company that should also be recognized as such under the law of the Netherlands without the latter Member State imposing further obligations on the UK company. With its reasoning the Court appealed to the mutual recognition in the field of company law.<sup>164</sup> However, *Wattel* convincingly stresses that mutual recognition has its difficulties in cross-border tax cases. He points out that the fact that one jurisdiction taxes certain income “[...] does not in any way justify prohibiting the other jurisdiction from exercising its taxing power as well.”<sup>165</sup> Reversely, the fact that one jurisdiction does not tax certain income does not grant a permit or obligation to the other jurisdiction to tax the same income if it would not do so otherwise. Additionally, he stresses that there is yet no rule which would serve as guidance as regards the question which Member State has to recognize which Member State's subjection to tax.<sup>166</sup> Admittedly, Art. 10 ATAD would give guidance on this question as it states that the Residence State shall respect the legal qualification of the financial instrument

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<sup>159</sup> Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 1', (*supra*, n. 96), p. 551.

<sup>160</sup> Brokelind, 'Legal Issues in Respect of the Changes to the Parent- Subsidiary Directive as a Follow-Up of the BEPS Project', (*supra* n. 47), p. 817.

<sup>161</sup> Art. 53 TFEU. See also Directive 2005/36/EC of the European Parliament and of the Council of 7. September 2005 on the recognition of professional qualifications, 30.09.2005, OJ L 255/22.

<sup>162</sup> Art. 67 TFEU.

<sup>163</sup> Art. 81 and 82 TFEU.

<sup>164</sup> CJEU, 30. Sep. 2003, C-167/01, *Inspire Art*, ECR [2003] I-10155.

<sup>165</sup> Wattel, 'Non-Discrimination à la Cour: The ECJ's (Lack of) Comparability Analysis in Direct Tax Cases', (*supra* n. 102), p. 543.

<sup>166</sup> Terra and Wattel, *European Tax Law*, (*supra* n. 94), p. 904.

given to it by the Source State. However, with regard to the *Inspire Art* judgement some differences to the field of tax law can be identified.

First, it must be born in mind that this decision does apparently not contain an *obiter dictum* which would indicate the CJEU's intention to render the statements made compulsory or to extent them to other fields of law.<sup>167</sup> Secondly, in *Inspire Art* the Court relied on the mutual recognition in order to prevent a EU company from suffering a less favourable treatment in another Member State. On the contrary, the linking rules impose a less favourable treatment on the payment receiving company in order to achieve tax symmetry by means of mutual recognition. Therefore, the Residence State would not effectively recognize the level of taxation in the Source State by accepting the fact that the latter provides for a deduction of the payment. The Residence State would rather override the legal situation in the Source State to its own benefit and in order to prevent double non-taxation.<sup>168</sup> Even though this ambition seems to be desirable, it appears critical from a EU law perspective when considering the CJEU's considerations regarding double taxation.<sup>169</sup> It was also seen in *Columbus Container* that the CJEU does not expect one Member State to recognize the legal characterization of a hybrid entity given to it by another Member State.<sup>170</sup>

Therefore, although mutual recognition can be regarded as a principle of EU law it cannot be regarded as an independent rule since it is rather dependent on the area of law to which it shall be applied.<sup>171</sup> With a view to the current stage of harmonization the principle of mutual recognition would be too far-reaching in direct tax matters and hence, a major breach to the Member States sovereignty.<sup>172</sup>

#### 4.3.4 Double Taxation/Double Non-Taxation and EU Law

In contrast to indirect taxes, harmonizing direct taxes was not seen as a necessary requirement for the establishing of an internal market but was rather seen as a useful tool in pursuing various economic and social aims by the Member States.<sup>173</sup> As a consequence, Member States stay competent with regard to direct taxes and retain the power to protect national public interests.<sup>174</sup> The parallel exercise of taxation rights can however cause double taxation.<sup>175</sup> Nonetheless, such dissuasive effects are rather caused by the concurrence of two, in themselves non-discriminatory domestic tax

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<sup>167</sup> Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 1', (*supra* n. 96), p. 544.

<sup>168</sup> Brokelind, 'Legal Issues in Respect of the Changes to the Parent- Subsidiary Directive as a Follow-Up of the BEPS Project', (*supra* n. 47), p. 822.

<sup>169</sup> See Ch. 4.3.4.

<sup>170</sup> CJEU, 6. Dec. 2007, C-298/05, *Columbus Container*, ECR [2007] I-10451. At issue was the German CFC legislation that provided for a switch over from the exemption to the credit method for foreign income. Since The Belgian hybrid entity was subject in Germany to taxation similar to German companies, no restriction was found.

<sup>171</sup> Weber, 'In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC', p. 591 – 593.

<sup>172</sup> *Ibid.*

<sup>173</sup> Adamczyk, 'The Sources of EU Law Relevant for Direct Taxation', (*supra* n. 20), p. 24.

<sup>174</sup> Terra and Wattel, *European Tax Law*, (*supra* n. 94), p. 69.

<sup>175</sup> See e.g. Schön, 'Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?', (*supra* n. 76), p. 274.

systems than by real discriminatory measures of a single Member State.<sup>176</sup> Therefore, such impediments (disparities) cannot be remedied by ways of negative integration.<sup>177</sup> These general statements become even clearer with a view to the CJEU's case law on in this context. The Court consistently pointed out that EU law, in its current stage of development, "[...] does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Community."<sup>178</sup> Additionally, some very interesting statements can be found in the *Banco Bilbao* case, where a Spanish company claimed for a deduction from its taxable base in Spain of interest expenses. The interest was paid to a non-related company in Belgium where this income was, however, exempted by virtue of the Belgian tax system. The Court held in its decision that "*Member States are not obliged to adapt their own tax systems to the different systems of tax of the other Member States in order, inter alia, to eliminate double taxation [...], a fortiori, those States are not required to adapt their tax legislation to enable tax payers to benefit from a tax advantage granted by another Member State in the exercise of its powers in tax matters, so long as their rules are not discriminatory.*"<sup>179</sup> Reversely, however, this argument can be understood as that Member States are not free to design their tax systems in a way that would refuse taxpayers from enjoying benefits in another Member State.<sup>180</sup>

What can be concluded from this case law is that juridical double taxation is in itself neither unlawful in the light of the fundamental freedoms, nor in any way assessable by way of negative integration.<sup>181</sup> EU law, in its current state, does simply not provide any criteria which would serve as valid reason for granting priority to the claims of one Member State involved.<sup>182</sup> In other words, the CJEU is not competent to decide on which Member State can exercise and which Member State has to waive its taxing right. This is rather a question of the allocation of taxation rights between the Member States which is predominately solved by virtue of DTC's. This pure allocation is however neutral in its effect and cannot be addressed by EU law.<sup>183</sup> This becomes very clear when considering the Courts reasoning in *Gilly*, where the Court accepted the existence of double taxation even though a DTC was concluded between Germany and France. The less favourable treatment that Mrs. Gilly suffered was, according to the

<sup>176</sup> Wattel, 'Non-Discrimination à la Cour: The ECJ's (Lack of) Comparability Analysis in Direct Tax Cases', (*supra* n. 102), p. 542.

<sup>177</sup> *Ibid.*

<sup>178</sup> CJEU, 14. Nov. 2006, C-513/04, *Kerckhaert and Morres*, ECR [2006] I-10981, para. 22; see also CJEU, 12. Feb. 2009, C-67/08, *Margarete Block*, ECR [2009] I-883, para. 30; CJEU, 16. July 2009, C-128/08, *Damseaux*, ECR [2009] I-6823, para. 45.

<sup>179</sup> CJEU, 8. Dec. 2011, C-157/10, *Banco Bilbao*, ECR [2011] I-13023, para. 39.

<sup>180</sup> Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 1', (*supra* n. 96), p. 552.

<sup>181</sup> With a different opinion see Frans Vanistendael, 'The ECJ at the Crossroads: Balancing Tax Sovereignty against the Imperatives of the Single Market' [2006] *European Taxation*, p. 413, 418. He concludes that double taxation is contrary to the fundamental freedoms as it infringes the principle of neutrality in the internal market.

<sup>182</sup> Wattel, 'Non-Discrimination à la Cour: The ECJ's (Lack of) Comparability Analysis in Direct Tax Cases', (*supra* n. 102), p. 543; Schön, 'Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?', (*supra* n. 40), p. 274.

<sup>183</sup> See in this regard the Opinion of Advocate General Colomer, 20. Nov. 1997, C-336/96, *Gilly*, ECR [1998] I-2796, para. 34, 44 and 45.



CJEU, the result of the different tax rates of the Member States involved and, therefore, the result of disparities between two tax systems.<sup>184</sup>

With regard to hybrid financial instruments, the fact that double taxation seems to be not assessable by EU law could also be understood as, in the same way, not prohibiting double non-taxation. If double taxation is deemed to be the simple consequence of the existence of different tax systems and therefore, the result of disparities, why could the same argument not also be true for double non-taxation? If Member States cannot prevent their residents from suffering double taxation in specific circumstances, why should they be obliged to put a more burdensome tax treatment on them if they agreed on waiving their taxing rights (inter alia for dividends) in the first place?<sup>185</sup> Are they protecting their own tax base or rather the tax base of the Source State? When the latter were true, why would a Member State be obliged to protect the tax base of another Member State and, further, is it even possible that EU law can be relied upon in order to worsen the tax situation of a taxpayer?<sup>186</sup> If double taxation situations triggered by hybrid financial instruments cannot be scrutinized under the fundamental freedoms – as they are simply the result of the exercise of different tax systems of two sovereign Member States – how could restrictive rules preventing double non-taxation, which arise for the same reason, be justified?

#### 4.4 Justification

Most likely the CJEU will establish a comparable situation and therefore a discrimination or restriction of either the freedom of establishment or the free movement of capital. Of great importance are therefore the considerations on the level of the justification/proportionality analysis.

In principle, the CJEU does not accept justification grounds not mentioned in the TFEU.<sup>187</sup> However, since the justification grounds provided for by the TFEU are not suitable for the field of tax law, the CJEU also allows unwritten justifications according to its so-called ‘rule of reason doctrine’.<sup>188</sup> According to that, a discriminatory or restrictive measure can be justified by overriding reasons of public interest given that the particular tax treatment is appropriate and does not go any further than necessary.<sup>189</sup> In its case law, the CJEU established several justifications grounds that are suitable for

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<sup>184</sup> CJEU, 12. May 1998, C-336/96, *Gilly*, ECR [1998] I-2823, para. 33. This judgement was however highly criticized since Mrs. Gilly suffered a real tax disadvantage. This disadvantage in the form of double taxation was however not the result of the disparities between the tax systems (which is in fact not assessable under EU law) but rather to due the interplay between the credit mechanism in the applicable DTC and the fact that Germany did not take into account her family circumstances. See also *Bukovansky*, C-241/14, (*supra* n. 109).

<sup>185</sup> Either by means of unilateral measures or by means of the PSD.

<sup>186</sup> The central aim of the fundamental freedoms is particularly to achieve an optimal allocation of resources by allowing factors of production to be moved to the area where they are most valued. Therefore, the fundamental freedoms aim to improve flexibility and wealth in the EU (see Craig and Búrca, *EU Law - Text, Cases, and Materials*, (*supra* n. 57), p. 582).

<sup>187</sup> Art. 36 TFEU. See also Terra and Wattel, *European Tax Law*, (*supra* n. 94), p. 59.

<sup>188</sup> This concept was developed by the CJEU for the first time in its decision CJEU, 20. Feb. 1979, C-120/78, *Rewe vs. Bundesmonopolverwaltung für Branntwein (Cassis de Dijon)*, ECR [1979] 650.

<sup>189</sup> See among others *Verkooijen*, C-35/98, (*supra* n. 139), para. 43.

the field of tax law.<sup>190</sup> With regard to the effects of hybrid financial instruments, Member State might possibly argue that restrictive measures preventing the use of such tax arbitrage are put in place in order to avoid double non-taxation or so-called ‘white income’.<sup>191</sup> However, such justification has never been accepted by the CJEU so far.<sup>192</sup> The justification grounds most closely linked to this argument – and therefore most relevant for the case at hand – will be examined in the following.<sup>193</sup>

#### 4.4.1 Safeguarding the balanced allocation of taxing rights

The justification ground of the need to protect the balanced allocation of taxing powers was, for the first time, accepted in *Marks & Spencer* but only in combination with other justification grounds.<sup>194</sup> Since then, this argument has been playing an important role in the CJEU justification analysis but can still not serve as a standalone justification.<sup>195</sup> In order for a restrictive measure to be justified the CJEU held that the system in question must be designed to prevent conduct capable of jeopardising the right of a Member State to exercise its tax jurisdiction in relation to activities carried out in its territory.<sup>196</sup> It is argued that linking rules do not have the intention to assure the taxation of activities carried out in the territory of the resident Member State but rather aim to align the tax treatment of a certain payment to that of another Member State and, therefore, intend to eliminate qualification conflicts.<sup>197</sup> This is an understandable argument since the resident Member State would, under ordinary circumstances, refrain from taxing inbound dividends in order to prevent economic double taxation. In other words, the Residence State would not, in any case, suffer the loss of its taxing power, as it would not tax the income in the first place. To argue that the taxation of inbound dividends – by means of re-characterization or denying exemption – would serve the protection of the tax base of a Member State would not reflect the economic and legal reality and purpose of such linking rules.

#### 4.4.2 Need to prevent double use of losses

The justification ground of the need to prevent ‘double dips’ was also accepted for the first time in *Marks & Spencer*.<sup>198</sup> Accordingly, restrictive unilateral measures can be

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<sup>190</sup> Terra and Wattel, *European Tax Law*, (*supra* n. 94), p. 60. Art. 65 TFEU provides additional justification grounds for restrictions of the free movement of capital.

<sup>191</sup> Jakob Bundgaard, ‘Hybrid Financial Instruments and Primary EU Law – Part 2’ [2013] Vol. 53, *European Taxation*, p. 587.

<sup>192</sup> *ibid.*; Englmair, ‘The Relevance of the Fundamental Freedoms for Direct Taxation’, (*supra* n. 97), p. 79 et seq.

<sup>193</sup> The justification grounds accepted by the Court, which are not discussed in this thesis, are the principle of territoriality, the effectiveness of fiscal supervision and the promotion of national education and training. See for further explanations regarding the application of these justifications by the Court Englmair, ‘The Relevance of the Fundamental Freedoms for Direct Taxation’, (*supra* n. 97), p. 72 et seq.

<sup>194</sup> CJEU, 13. Dec. 2005, C-446/03, *Marks & Spencer*, ECR [2005] I-10866, para. 43 et seq.

<sup>195</sup> CJEU, 8. Nov. 2007, C-379/05, *Amurta*, ECR [2007] I-9594, para. 56; Bundgaard, ‘Hybrid Financial Instruments and Primary EU Law – Part 2’, (*supra* n. 191), 589.

<sup>196</sup> See inter alia *Marks & Spencer*, C-446/03, (*supra* n. 194), para. 46; *Société de Gestion Industrielle (SGI)*, C-311/08, (*supra* n. 124), para. 60.

<sup>197</sup> Bundgaard, ‘Hybrid Financial Instruments and Primary EU Law – Part 2’, (*supra* n. 191), 589.

<sup>198</sup> *Marks & Spencer*, C-446/03, (*supra* n. 194), para. 47. See also CJEU, 28. Feb. 2008, C-293/06, *Deutsche Schell*, ECR [2008] I-1129, para. 51; CJEU, 15. May 2008, C-414/06, *Lidl Belgium*,

justified if they aim to prevent that economically identical losses are deductible at the level of the parent company as well as at the level of the subsidiary. In contrast to the BEPS report, which also recommends targeting DD outcomes,<sup>199</sup> the linking rules in question capitalize only on D/NI outcomes. Even if the deduction in the Source State without a corresponding inclusion in the taxable base in the Residence State would be considered as being of the same economic value as the double deduction of losses in both States, in any case, preventing the double use of losses would never serve as a stand-alone justification ground.<sup>200</sup> Further in this regard, AG *Kokott* convincingly stressed in this context that a Member State is, first, not required to draw up its tax rules on the basis of those in another Member State in order to prevent a difference in treatment of cross-border establishments. Secondly, a Member State can also not rely on the tax rules of another Member States as justification for the difference in treatment of its own.<sup>201</sup> Additionally, it can also be pointed out at this point that another justification ground, which has never been accepted by the CJEU, is the loss of tax revenue.<sup>202</sup> A linking rule does not have the purpose to protect the Residence States tax base since this State initially renounced on its taxing right by means of exempting inbound dividends in order to avoid economic double taxation.

#### 4.4.3 Prevention of tax avoidance and abuse

The CJEU has been reserved in accepting the prevention of tax avoidance as a justification ground.<sup>203</sup> However, lately the Court developed particular standards that domestic legislation has to comply with in order to be justified by the need to prevent tax avoidance. In *Halifax*<sup>204</sup>, which concerned the set up of a complex structure by a UK bank in order to achieve a more favourable VAT treatment, the CJEU established for the first time two criteria in order to determine whether there is an abusive arrangement or not. First, the particular practice must result in obtaining a tax advantage which is contrary to the provisions of EU law<sup>205</sup> and second, the obtaining of this tax advantage is the sole or essential purpose of the transaction.<sup>206</sup> In the same year and with regard to direct taxes the CJEU had to decide about the British CFC scheme that targeted structures through which profits could be shifted to low tax countries through the establishment of a subsidiary.<sup>207</sup> The restrictive national measures were therefore only justified and proportionate if they aimed to “[...] prevent conduct

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ECR [2008] I-3601, para. 36; CJEU, 6. Sep. 2012, C-18/11, *Philips Electronics UK*, not published in ECR, para. 28.

<sup>199</sup> See 3.1.2.

<sup>200</sup> E.g. Opinion of Advocate General Kokott, 27. Feb. 2014, joined cases C-39/13, C-40/13, C-41/13, *SCA Group Holding and Others*, not published in ECR, para. 47. See also in this sense Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 2', (*supra* n. 191), p. 590.

<sup>201</sup> Opinion of Advocate General Kokott *SCA Group Holding and Others*, joined cases C-39/13, C-40/13, C-41/13, (*supra* n. 200), para. 50.

<sup>202</sup> See e.g. *Verkooijen*, C-35/98, (*supra* n. 189), para. 48.

<sup>203</sup> 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*, p. 163, 166.

<sup>204</sup> CJEU, 21. Feb. 2006, C-255/02, *Halifax and Others*, ECR [2006] I-1609.

<sup>205</sup> *Ibid.*, para. 74.

<sup>206</sup> *Ibid.*, para. 75.

<sup>207</sup> *Cadbury Schweppes*, C-196/04, (*supra* n. 84).

*involving the creation of wholly artificial arrangements which do not reflect economic reality [...].*<sup>208</sup> The Court established in this regard a so-called motive test that consists out of both a subjective and an objective element. Subjectively, there must be the intention to obtain a tax advantage and objectively, the activity pursued must lack real economic substance in the other, low tax Member State.<sup>209</sup> Accordingly, the mere fact that a subsidiary is subject to low taxation in the Source State cannot, in itself, justify restrictive measures by the resident state in order to offset this particular advantage.<sup>210</sup> EU citizens are free to organize their business in a way that seems to be most advantages for them without running the risk of being accused of abuse.<sup>211</sup> To introduce compensatory tax arrangements would prejudice the very foundations of the single market.<sup>212</sup>

The linking rule introduced by Art. 10 does neither only address wholly artificial arrangements<sup>213</sup> nor does it give the taxpayer the opportunity to show that the activity at issue conducts a genuine economic activity. In implementing a measure such as the one proposed, Member States would be obliged to limit the re-characterization of dividend income into interest income on situations which lack economic reality. Choosing a certain financing structure cannot be, as such, wholly artificial or, in general, be regarded as abusive. It is therefore extremely important to draw a line between the use and the abuse of taxpayer rights.<sup>214</sup> Only if an arrangements lack economic reality and aims exclusively to exploit qualifications conflicts, a re-characterization of tax-exempt income to taxable income may be justified. The mismatch outcomes are however the result of a different qualification of the same instrument in another jurisdiction on which the Residence Member State has no influence. Indeed, limiting the scope of anti-hybrid rules only on wholly artificial arrangements would not be as efficient as aspired since such arrangements usually possess economic reality.<sup>215</sup> The use of a particular advantageous tax system of another Member State is precisely one of the main objectives of the internal market.<sup>216</sup> A resulting double non-taxation would therefore not as such be abusive and could not be justified since the measure used would go far beyond what would be considered necessary.<sup>217</sup>

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<sup>208</sup> *Ibid.*, para. 55.

<sup>209</sup> *Ibid.*, para. 64.

<sup>210</sup> *Ibid.*, para. 49.

<sup>211</sup> *Centros*, C-212/97, (*supra* n. 37), para. 27.

<sup>212</sup> *Eurowings*, C-294/97, (*supra* n. 113), para. 45.

<sup>213</sup> Later on the CJEU did also address partly artificial arrangements *Test Claimants in the Thin Cap Group Litigation* C-524/04, (*supra* n. 84), para. 80 – 83.

<sup>214</sup> Evgenia Kokolia and Evgenia Chatziioakeimidou, 'BEPS Impact on EU Law: Hybrid Payments and Abusive Tax Behaviour' [2015] *European Taxation*, p. 149, p. 153.

<sup>215</sup> Helminen, 'EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements', (*supra* n. 22), p. 333; Bundgaard, 'Hybrid Financial Instruments and Primary EU Law – Part 2', (*supra* n. 191), p. 591.

<sup>216</sup> Dennis Weber, *Tax Avoidance and the EC Treaty Freedoms: A Study of the Limitations under European Law for the Prevention of Tax Avoidance* (Kluwer Law International 2005), p. 196.

<sup>217</sup> See for further considerations regarding the justification analysis in case of domestic anti-tax avoidance measures, particularly with regard to the principle of legal certainty Maria Hilling,

#### 4.4.4 Coherence

The ATAD aims to lay down rules in order to discourage tax avoidance practices and ensure fair and effective taxation in the Union in a sufficiently coherent and coordinated fashion.<sup>218</sup> It might be interesting to examine whether the application of the proposed measures will actually result in a coherent treatment from a EU law perspective.

Generally, the coherence of the tax system is a concept to avoid double taxation or to ensure that income is taxed at least once.<sup>219</sup> It was accepted for the first time in the *Bachmann*<sup>220</sup> case but was subsequently rejected by the CJEU to a great extent. The second and also the most recent, case where the CJEU accepted the cohesion argument was in *Krankenheim*.<sup>221</sup> From the consideration in these cases some insights can be derived under which circumstances a national measure can be justified by the argument that they serve to achieve the coherence of the tax system. Accordingly, it is necessary that a ‘direct link’ exist between the tax advantage and the tax disadvantage in question.<sup>222</sup> This can only be assumed if the advantage and disadvantage relate to the same income and the same taxpayer.<sup>223</sup> Therefore, the taxation of corporate profits of a company cannot have a direct link to the tax treatment of the dividends distributed to its shareholder.<sup>224</sup> The coherence argument would, as a consequence, not justify a less favourable treatment for foreign subsidiaries. This distinct statement can be inferred from the CJEU’s statements in – inter alia – *Eurowings*,<sup>225</sup> *Verkooijen*<sup>226</sup> and *Lenz*.<sup>227</sup> The Court rejected the idea that a lower or missing taxation in another Member State can be compensated by a restrictive national measure.

On the other hand, the CJEU found in *Marks & Spencer* that profits and losses must be treated symmetrically as they are two sides of the same coin.<sup>228</sup> A direct link was therefore established even though there were two separate taxpayers involved.<sup>229</sup> The same is true for the *Manninen* case where the Court also saw the direct link between two separate taxpayers.<sup>230</sup> Also AG Kokott stressed in her opinion to *Manninen* that, “[...] exceptionally, a link justifying the tax cohesion argument may exist if a charge on

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‘Justifications and Proportionality: An Analysis of the ECJ’s Assessment of National Rules for the Prevention of Tax Avoidance’ [2013] Vol. 41, Intertax, p. 249

<sup>218</sup> COM(2016) 26 final, (*supra* n. 11), recital (2).

<sup>219</sup> Englmair, ‘The Relevance of the Fundamental Freedoms for Direct Taxation’, (*supra* n. 97), p. 72.

<sup>220</sup> CJEU, 28. Jan. 1992, C-204/90, *Bachmann*, ECR [1992] I-249.

<sup>221</sup> CJEU, 23. Oct. 2008, C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt*, ECR [2008] I-8061.

<sup>222</sup> *Bachmann*, C-204/90(*supra* n. 220), para. 21. See also regarding the development of the coherence justification ground Louan Verdoner, ‘The Coherence Principle under EC Tax Law’ [2009] European Taxation, p. 274.

<sup>223</sup> *Baars*, C-251/98, (*supra* n. 83), para. 40; *Verkooijen*, C-35/98, (*supra* n. 189), para. 57.

<sup>224</sup> Helminen, ‘EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements’, (*supra* n. 22), p. 335. See also *Lenz*, C-315/02, (*supra* n. 116), para. 37 et seq, where the CJEU rejected the proportionality of such measure.

<sup>225</sup> *Eurowings*, C-294/97, (*supra* n. 113), para. 44.

<sup>226</sup> *Verkooijen*, C-35/98, (*supra* n. 189), para. 57.

<sup>227</sup> *Lenz*, C-315/02, (*supra* n. 116), para. 42.

<sup>228</sup> *Marks & Spencer*, C-446/03, (*supra* n. 194), para. 43.

<sup>229</sup> Helminen, ‘EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements’, (*supra* n. 22), p. 336.

<sup>230</sup> *Manninen*, C-319/02(*supra* n. 117), para. 45. This link was, however, not seen in *Verkooijen*.

*one taxpayer is offset by a relief for another [...]*<sup>231</sup> whenever the tax is at least levied on the same income or the same economic process.<sup>231</sup> She argued further that the reliance on the latter precondition would be just as effective as the criterion of the same taxpayer in ensuring that justification on the grounds of cohesion of the tax system does not run out of control.<sup>232</sup> Most recently, however, the CJEU decided about a German inheritance tax case which contains some interesting insights on how the Court deals with the so-called correspondence principle (Korrespondenzprinzip).<sup>233</sup> According to the German legislation at issue a non-resident cannot deduct from its income received from Germany the pensions paid to his parents. As the German government put forward the coherence argument the CJEU pointed out that there is no direct link between the deduction of the pension payments and the taxation of pension income at the level of the same taxpayer.<sup>234</sup> It is therefore not clear whether the CJEU still relies on the direct link as regards the same taxpayer or not. In any case, however, the anti-hybrid rule contained in the ATAD would usually address two separate taxpayers. Nonetheless, it would require the application overall approach in order to justify the denial of the dividend exemption by the Residence State on the grounds of coherence. It was examined earlier<sup>235</sup> that the use of the overall approach might severely undermine the sovereignty of the Member States. In this respect Advocate General (AG) Mengozzi made a very convincing argument in his opinion to the *Amurta*<sup>236</sup> case. He stated that “*the discriminatory effects of national legislation on a taxpayer [cannot] be neutralised by benefits granted to him under the legislation of another Member State. To accept the contrary would [...] be tantamount to allowing a Member State to avoid its obligations under Community law by making compliance dependent on the possible effects of the national legislation of another Member State, which may be amended unilaterally at any time by that State.*”<sup>237</sup> The Court followed this approach in its later decision.<sup>238</sup> Additionally, it appears also critical in the light of the coherence argument if the anti-hybrid rule only addresses double non-taxation situation but not, at the same time, double taxation outcomes.<sup>239</sup>

With regard to Art. 10 ATAD it was examined earlier<sup>240</sup> that it is not clear how far-reaching a re-characterization of tax-exempt dividend income into taxable interest income would be as regards the remaining tax treatment of that payment in the national tax system of the Residence State. If the treatment of the payment as interest income would be compulsory for all subsequent tax assessments of the receiving company, one could argue that there could be a compensating advantage with a view to the national

<sup>231</sup> Opinion of Advocate General Kokott, 18. March 2004, C-319/02, *Manninen*, ECR [2004] I-7480, para. 61.

<sup>232</sup> *Ibid.*, para. 62.

<sup>233</sup> CJEU, 24. Feb. 2015, C-559/13, *Grünwald*, not yet published.

<sup>234</sup> *Ibid.*, para. 47 – 49.

<sup>235</sup> See Ch. 4.3.2.4.

<sup>236</sup> *Amurta*, C-379/05, (*supra* n. 236).

<sup>237</sup> Opinion of Advocate General Mengozzi, 7. June 2007, C-379/05, *Amurta*, ECR [2007] I-9573, para. 78.

<sup>238</sup> *Amurta*, C-379/05, (*supra* n. 236), para. 75.

<sup>239</sup> Kahlenberg and Kopeck, 'Hybrid Mismatch Arrangements – A Myth or a Problem at Still Exists?', (*supra* n. 26), p. 74.

<sup>240</sup> See Ch. 3.3.

interest deduction limitation rules. The interest income would, at the same time, raise the amount of interest expenses which could be deducted for tax purposes. However, some doubts to this view exist.

First of all, also in this case the CJEU must examine whether there is a direct link between the tax advantage and the disadvantage in question as regards the tax subject and the tax object. The offsetting of tax disadvantages by unrelated tax advantages has never been accepted by the CJEU as justification, even if such advantages exist.<sup>241</sup> Additionally, it is not clear whether the taxpayer would effectively benefit from such additional interest income in the course of the interest deduction limitation rules. This would be a question for the CJEU to examine on a case-by-case basis. Therefore, a general justifiability seems to be more than questionable.

#### 4.5 Proportionality

In a final step the CJEU would scrutinize a restrictive but justified measure on its proportionality. In other words, the Court would examine whether a particular measure is appropriate and does not go beyond what would be necessary to achieve the result pursued. Since there is no possible justification ground available in the case of linking rules the analysis of the proportionality of linking rules is not necessary.

#### 4.6 Final Remarks

The previous analysis demonstrated that linking rules, which aim to neutralize double non-taxation outcomes caused by hybrid financial instruments, cannot be regarded as compatible with EU law. This is not different whether a domestic provision or a measure of secondary EU law is concerned. The target pursued by linking rules, namely, to secure that every income should be taxed once somewhere, must however be seen as a reflection of the *single tax principle*. This principle states that every income should be subject to tax once, but only once, and therefore rejects both the occurrence of double taxation and double non-taxation.<sup>242</sup> Even though the single tax principle is not officially referred to as a principle of EU law it is, nonetheless, one of the most fundamental principles of international tax law that has its roots in the early 1920's and which served as the foundation of DTC's as we know them today.<sup>243</sup>

One possibility to secure single taxation in the case of hybrid financial instruments could be a switchover from the exemption to the credit method. The PSD leaves it up to the Member States to choose either one of those methods in order to avoid economic double taxation.<sup>244</sup> Most Member States, however, promote capital import neutrality by exempting foreign dividend income in order to attract foreign investments. A switchover on a case-by-case basis would therefore be preferable over a general switchover from the exemption to the credit method, as the latter would potentially

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<sup>241</sup> *Commission vs. France (Avoir Fiscal)*, 270/83, (*supra* n. 82), para. 21; *Dijkman and Dijkman-Lavaleije*, C-233/09, (*supra* n. 86), para. 43.

<sup>242</sup> That the rejections of double non-taxation forms an essential part of the single tax principle is convincingly presented by Reuven S. Avi-Yonah, *Advanced Introduction to International Tax Law* (Edward Elgar 2015), p. 59 et seq.

<sup>243</sup> *Ibid.*, p. 3 et seq.

<sup>244</sup> See recital (11) of the Explanatory Memorandum and Art. 7.2 PSD.

interfere with the Member States economic interests. Even though a taxpayer would, as a result, suffer a higher tax burden, it is reasonable to assume that no restriction of primary EU law occurs. It was established in *Columbus Container* that a switchover from exemption to credit method might lead to a higher tax burden which is, however, not higher than the tax burden that also other taxpayers in the Residence State would be subject to.<sup>245</sup> The credit method would lift up the tax burden of inbound dividend on a domestic level which would compensate the lack of taxation in the source state in the case of hybrid financial instruments.

Additionally, a GAAR could serve to tackle hybrid mismatch arrangements. The recently amended GAAR of the PSD now states that arrangements, of which it is the main purpose, or one of the main purposes, to obtain a tax advantage that defeats the object or purpose of the PSD and that are not genuine, shall not enjoy the benefits of the directive.<sup>246</sup> Also the ATAD contains a GAAR which states that non-genuine arrangements shall be ignored for the purposes of calculating the corporate tax liability if they are carried out for the essential purpose of obtaining a tax advantage that defeats the object or purpose of the otherwise applicable tax provisions. Valid commercial reasons, which reflect economic reality, must exist. In this regard the case law of the CJEU on *Halifax*<sup>247</sup> and *Cadbury Schweppes*<sup>248</sup> must be recalled and respected. As it was already pointed out, in most cases, it is not a challenge to present a certain degree of economic reality and valid commercial reasons in the case of hybrid financial instruments. Because of that, the linking rules introduced in the PSD and the ATAD do not – presumably intended – only target wholly artificial arrangements. Therefore, whether a GAAR could effectively tackle double non-taxation caused by hybrid financial instruments can be questioned.

It was also put forward that the problem of double non-taxation within the EU could possibly be solved through a multilateral EU tax treaty based on the Nordic Convention which.<sup>249</sup> However, the particular provisions, which would address intended as well as unintended double non-taxation, would have to be limited to a certain extent as they must also comply with EU law.<sup>250</sup> Lastly, it can be concluded that increased coordination and common standards could be regarded as a reasonable and more effective alternative to such linking rules.<sup>251</sup>

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<sup>245</sup> *Columbus Container*, C-298/05, (*supra* n. 170).

<sup>246</sup> See Art. 1(2) PSD.

<sup>247</sup> *Halifax and Others*, C-255/02, (*supra* n. 204).

<sup>248</sup> *Cadbury Schweppes*, C-196/04, (*supra* n. 84). See also Ch. 4.4.3.

<sup>249</sup> Marjaana 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*, p. 306.

<sup>250</sup> *Ibid*, p. 310 and 312.

<sup>251</sup> In this regard the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011)121 final — 2011/0058 (CNS), 28.01.2012, OJ C 24/63 should be mentioned since it would serve as a common standard as regards the determination of the taxable base of MNE's.



## 5 Conclusion

There has not yet been any case law on hybrid financial instruments decided by the CJEU. With the view to the on-going discussion in this respect it might however be just a matter of time until a case will find its way to the Court and will serve as a first juridical precedent.

It has been demonstrated that linking rules pose several questions and doubts as regards the neutralization of the adverse effect caused by hybrid financial instruments. A difference in treatment becomes particularly clear when considering a situation, where the exemption of foreign dividend income is denied, compared to a purely domestic or another cross-border situation in which tax exemption is ensured. Of course, arguments can be found in favour of the assumption that the lack of taxation in the Source State would compensate the less favourable tax treatment in the Residence State. However, it was convincingly determined that this assumption is contrary to a well-established line of case law that has been developed by the CJEU over the last decades. Accordingly, the level of taxation in another Member State cannot compensate a less favourable tax treatment imposed on a taxpayer by its Residence State. In examining whether a linking rule establishes a restriction on the receiver by its Residence State, the CJEU should therefore disregard the tax situation in another country.

The question about the EU conformity of linking rules such as those proposed by the PSD and the ATAD brings into the light the fundamental conflict of the aim to establish an internal market by guaranteeing tax neutrality and the sovereignty of the EU Member States as regards direct taxation. Hence, with a view to direct taxation, no EU law obligation for Member States exists to mutually recognize their tax systems. The fact that one Member State does not tax certain income does not automatically grant the right of taxation to another Member State. Such allocation of taxing powers is predominately addressed by means of bilateral agreements. Additionally, the CJEU in several occasions pointed out explicitly that double taxation, as a result of the parallel exercise of taxing rights by sovereign Member States, is an impediment to the internal market which is, however, not assessable under the TFEU. Hence, there are reasonable doubts whether the consequence of double non-taxation caused by the same reason can be scrutinized under the fundamental freedoms. It was further shown that a restriction, such as denying the tax exemption on dividend income due to a different legal characterization in the Source State, would most likely not be justified by overriding reasons of public interest.

It remains to be seen which concept the European Commission will introduce in the course of the ATAD, if ever adopted. The next statements in this regard cannot be expected before the 17<sup>th</sup> June 2016, when the ECOFIN will again discuss the current state of development of the proposal.<sup>252</sup> Up to this date, however, EU law in its current state does not permit one Member State to make the tax treatment of certain income dependent upon the tax treatment of the corresponding payment in another Member State.

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<sup>252</sup> See for further information 'Economic and Financial Affairs Council meeting - Anti tax avoidance directive', (*supra* n. 70).

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