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# Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 2

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**In this two-part article, the author addresses the application of EU tax directives to hybrid financial instruments. In Part 1, the applicability of the Parent-Subsidiary Directive and the Interest and Royalties Directive was analysed. In Part 2, unilateral measures of Member States to combat cross-border arbitrage are discussed. Moreover, Part 2 contains an analysis of the fulfilment of the holding requirements under the directives and the application of the Arbitration Convention.**

## 4. Do the Directives Hinder Member States from Curbing Cross-Border Tax Arbitrage?

### 4.1. Domestic response to cross-border tax arbitrage through the use of hybrid financial instruments

In recent years some Member States have enacted provisions that limit the scope of the Parent-Subsidiary Directive in order to combat cross-border tax arbitrage. In the European context, two legislative approaches are used to neutralize the effect of cross-border tax arbitrage:

(1) Limiting the scope of the participation exemption regime if the payments on hybrid financial instruments (HFIs) are deductible at the level of the issuing company; and

(2) Restricting interest deductibility at the level of the issuing company if the instrument is treated as equity in the state of residence of the investor.

Only the first approach is analysed in the context of the EU directives.[132] Below, the existing domestic provisions, providing for the tax treatment mentioned under (1), are briefly introduced. These provisions, in effect, are specific anti-arbitrage provisions that introduce unilateral synchronization measures. The analysis then deals with the possible view of the ECJ on tax arbitrage under the Parent-Subsidiary Directive. The Interest and Royalties Directive specifically addresses HFIs and tax arbitrage under Art. 4. Accordingly, there is no need for a specific analysis of the Interest and Royalties Directive in this context.

#### 4.1.1. *The United Kingdom (2005 and 2009)*

In 2005, the United Kingdom introduced tax law provisions under the Finance Act to combat tax arbitrage, including arbitrage arising through the use of hybrid finance.[133] The legislation is aimed at eliminating the UK element of double-dip structures (including real double-dip structures and deduction/non-inclusion structures). The purpose of the provision is to prevent businesses from converting interest payments into capital gains, dividends or tax-exempt income and it targets structures where the main purpose or one of the main purposes is to obtain a UK tax benefit. The relevant test is "the main purpose test".[134] Guidance on the legislation has been issued by the UK tax authorities.[135] The UK legislation has effect both with respect to the deductibility and tax treatment of payments received from HFIs. The legislation is highly complex and gives rise to a number of uncertainties.

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132. Interest deduction restrictions may have similar effects as withholding taxes. It is, however, submitted that an interest deduction restriction should not be considered a withholding tax under the directives. Even though the ECJ has laid down a broad interpretation of the term "withholding tax", the court clearly rejected that the taxation of a subsidiary corresponds to taxing the parent company, where the tax is withheld by the company distributing the profits and paid directly to the tax authorities; see ECJ, 26 June 2008, Case C-284/06, *Burda Verlagsbeteiligungen GmbH v. Finanzamt Hamburg-Am Tierpark*, Para. 53 et seq. In this case, the ECJ gave weight to the condition that the taxable person must be the "holder of the shares" and not the distributing company. This decision clearly supports the above conclusion that an interest deduction restriction is not similar to a withholding tax. Based on this the domestic restrictions in tax arbitrage situations are not analysed.

133. See Finance (No. 2) Act 2005, Secs. 24 to 31 and Schedule 3. The background to the introduction of the legislation was criticized by M. Boyle, "Cross Border Tax Arbitrage – Policy Choices and Political Motivations", *British Tax Review* 5 (2005), p. 527 et seq.

134. See D. Hill and E. Nendick, "UK: Government continues to clamp down tax avoidance", *International Tax Review* (2006), Supplement – Capital Markets.

135. See Her Majesty's Revenue and Customs (HRMC) Guidance, FA 96/S91A-G, under the heading "Taxing Loan Relationships: Anti-Avoidance: Shares as Debt" and HMRC, "Avoidance Involving Tax Arbitrage", Guidance Notes.

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In terms of receipts in the United Kingdom, the following requirements must be fulfilled:[136]

- a company has entered into a scheme under which it receives an amount on which it is not liable to UK tax;
- that amount may be deducted from or allowed against taxable income of the person undertaking the payment;
- the arbitrage – in this case a mismatch in tax treatment – is a reasonable expectation of the parties to the scheme; and
- the payment constitutes a contribution to the capital of the company.

The effect of fulfilling these requirements is that the receipts are considered taxable income.[137] Based on the UK anti-arbitrage provision, it has been recommended to corporate taxpayers to make sure that there are other reasons for the use of HFIs than mere fiscal ones.[138] It seems this will also affect the Parent-Subsidiary Directive when dividends are tax exempt in the United Kingdom. A participation exemption was only introduced in 2009.[139] According to the legislation recently adopted, dividends received are generally taxable if they are not exempt.[140] An exemption is granted regarding distributions received by "small companies" (Sec. 931B Corporate Tax Act (CTA)) and other companies that are not "small" (Sec. 931D CTA).[141] The provisions are designed to ensure that the majority of dividends will be exempt.[142] The provisions set out certain requirements in order to qualify for an exemption. One common requirement is that, "no deduction is allowed to a resident of any territory outside the United Kingdom under the law of that territory in respect of the distribution".[143]

### *4.1.2. Germany 2007*

As a part of the 2007 German Annual Tax Act (*Jahressteuergesetz* – JStG), certain changes were made to combat tax arbitrage in the context of the tax treatment of interest on outbound shareholder loans.[144] The amendments narrowed the scope of the domestic participation exemption provision in Sec. 8(b) of the Corporate Income Tax Act (*Körperschaftsteuergesetz*, KStG) both regarding reclassified interest in the form of constructive dividends and income exempt under a tax treaty. Clearly, the changes are relevant in the context of cross-border arbitrage. One of the changes is also relevant in the context of the EU directives. Under the German thin capitalization provision in Sec. 8(a) of the KStG, the treatment of interest payments on loans granted by domestic shareholders was also treated as dividends; this offered domestic corporate creditor shareholders an opportunity to benefit from a classification as interest in the foreign jurisdiction and as a dividend in Germany. The limitation of the scope of the participation exemption regime that was enacted with respect to constructive dividends (*verdeckte Gewinnausschüttungen*) requires that the interest payment is deductible in the state of the debtor. The amendments are not specifically aimed at HFIs, but they represent domestic countermeasures against cross-border tax arbitrage that may affect HFIs.

### *4.1.3. Denmark 2007 and 2009*

In 2007, a specific provision aimed at tax arbitrage structures using inbound hybrid financial instruments was introduced under Danish tax law. The specific anti-arbitrage provision was introduced as Sec. 2(b) of the CTA.[145] For some years now Denmark's fiscal policy has been to make the domestic tax treatment of certain transactions dependent on the tax treatment in other jurisdictions.[146] The underlying rationale for this tax policy has been widely criticized due to the fact that Denmark thereby takes on a coordinating role between different countries regarding the classification of HFIs, while a similar effort is not made in regard to double taxation resulting from cross-border transactions due to a different classification of the same financial instrument. Recently, any doubts with respect to the applicability of the Danish participation exemption regime in situations of cross-border tax arbitrage, through the use of outbound HFIs, were eliminated. In 2009, the wording of Sec. 13(1)(2) of the CTA was amended in order to exclude dividend payments that are, in fact, tax deductible in the country of the paying company unless the dividends fall within the scope of the Parent-Subsidiary Directive.[147] The following analysis will demonstrate whether or not this reservation was even necessary.

136. See HRMC, "Avoidance Involving Tax Arbitrage", note 135, Para. 53.
137. Id.
138. See Hill and Nendick, note 134.
139. See Finance Act 2009, Schedule 14, which provides a new part 9 A of the Corporate Tax Act (CTA). Prior to this, the United Kingdom had a modified imputation system.
140. See Sec. 931A of the CTA.
141. See, for an interpretation, "Distribution exemption – draft guidance", HMRC 2009; P. Cussons, "UK Government proposals for the taxation of foreign profits" *British Tax Review* 1 (2009), p. 1 et seq. and P. Voisey, "Legislative Comment Finance Act Notes: Section 34 and Schedule 14 – Corporation Tax Treatment of Company Distributions Received", *British Tax Review* 5 (2009), p. 533 et seq.
142. See Distribution exemption – draft guidance, note 141, p. 1.
143. See Secs. 931B(c) and 931D(c) CTA.
144. See, for example, H. Plewka and K. Beck, "German Tax Issues for Hybrid Forms of Financing, *Tax Notes International*, 30 October 2006, p. 375 et seq. and the same in *Tax Notes International*, 6 November 1996, p. 453 et seq.; O. Dörfler, R. Heurung and G. Adrian, "Korrespondenzprinzip bei verdeckter Gewinnausschüttung und verdeckter Einlage", DStR (2007), p. 514 et seq. and T. Kollruss, "Weisse und Graue Einkünfte bei Outbound-Finanzierung einer ausländischen EU-Tochtergesellschaft nach Europarecht und dem JStG 2007", *Betriebs-Berater* 62 (2007), p. 467 et seq.
145. See Act No. 344 enacted on 18 April 2007, based on Bill No. L 110 B. The provision and its background were analysed by J. Bundgaard, "Cross-Border Tax Arbitrage from Inbound Hybrid Financial Instruments Curbed in Denmark by Unilateral Reclassification of Debt to Equity", *Bulletin for International Taxation* 1 (2008), p. 33 et seq.
146. See, in general, A. Michelsen, "Samspillet mellem intern danske skatteregler og interne skatteregler i andre lande" in K. Ståhl & P. Thorell (eds.), *Festskrift til Mattson* (2005), p. 277 et seq.
147. See Act No. 98 of 10 February 2009 (Based on Bill L 23). Prior to this it was subject to debate whether or not the legislation contained authority for this result; see Bundgaard, note 145.

## 4.2. Interaction of the domestic measures with the EU corporate tax directives

### *4.2.1. Does tax arbitrage constitute fraud or abuse under the directives?*

#### *4.2.1.1. In general*

In this section, the overall principle underlying the domestic response to tax arbitrage is examined in light of the directives for the purpose of determining whether or not such domestic responses conflict with the directives. In this analysis, it is first assessed whether or not the "fraud and abuse" clause of the Parent-Subsidiary Directive allows Member States to deny directive benefits in situations of cross-border tax arbitrage resulting from the use of HFIs. This scenario may, for instance, occur in the context of certain non-voting preference shares as seen in at least one Member State. According to domestic GAAP, such non-voting shares must be registered in the accounts as debt and distributions related to non-voting shares should be considered as deductible. At the same time, the shares are considered shares and the yield considered dividends in the state of the recipient.

The opinion of the Commission regarding tax arbitrage is clearly stated in Para. 2.3 of COM(2006) 823 final:

> Hiatuses between tax systems due to a lack of co-ordination may also lead to unintended nontaxation and provide scope for abuse. Non-taxation and abuse are equally detrimental to the interests of the Internal Market because they undermine the fairness and the balance of Member States' tax systems. This problem can also be addressed by better co-ordination of Member States' rules and improved co-operation with respect to enforcement. This will be an essential element of the Commission's initiatives, and the Commission proposes to examine this area together with Member States in a working group in the near future depending on the progress of relevant ECJ case law.

As a follow-up, HFIs were specifically addressed in the following statement on p. 6 of COM(2007) 785 final:

> […] Lack of concerted interaction between MS's tax systems may result in unintended non-taxation and provide scope for abuse, thus undermining their fairness and balance. Mismatches may arise, for example, in relation to the qualification of debt and equity. One MS may consider a transaction to be an equity injection and thereby exempt the income derived from it (as a profit distribution), whereas another MS may consider the same transaction to be a loan and allow tax deductibility for the consequent payments (as interest). This may result in a deduction in one MS without corresponding taxation in another MS […].

In light of the Commission's decision to develop new coordinated solutions, tax arbitrage does not seem (in the view of the Commission) to be considered abuse *de lege lata*. The basic question, whether or not an arrangement leading to double non-taxation is an abuse of EU law, remains unanswered.[148]

Both directives contain fraud and anti-abuse clauses; for example, Art. 1(2) of the Parent-Subsidiary Directive and Art. 5(1) of the Interest and Royalties Directive. According to these provisions the respective directive does not prevent the application of domestic or agreement-based provisions required for the prevention of fraud or abuse. The Member States may, furthermore, pursuant to Art. 5(2) of the Interest and Royalties Directive, in regard to transactions in respect of which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse, withdraw the benefits of the directive or refuse to apply the directive.

These provisions are subject to an EU law interpretation. The following analysis focuses on the Parent-Subsidiary Directive, since the domestic legislation in question concerns dividend taxation and since the Interest and Royalties Directive specifically addresses HFIs and tax arbitrage under Art. 4.

The ECJ determines, with binding effect, whether a refusal by a Member State of the benefits of a directive under domestic legislation is in compliance with the directive. It may be assumed that the ECJ will interpret the provision in Art. 1(2) in accordance with its general findings on fraud and abuse, as it seems obvious that these provisions reflect the ordinary EU law prohibition against abuse of rights.[149]

In recent years, in particular, the ECJ has decided a number of cases in the tax law area relating to the question of abuse of EU law.[150] In several cases the ECJ has stated that it is acceptable to introduce domestic legislation aimed at preventing tax avoidance.[151] Thus, the ECJ's practice has been to hold that domestic legislation that limits the freedom of establishment may be justified when it specifically targets "purely artificial arrangements with the objective of circumventing the relevant member state's legislation".[152] The line between acceptable tax avoidance and unacceptable tax evasion was clarified by the ECJ in its decision in *Cadbury Schweppes*.[153] The ECJ states that:

> It follows that, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial

148. See L. De Broe, "Some obervations on the 2007 communication from the Commission: The application of anti-abuse measures in the area of direct taxation within the EU and in relation to third countries", *EC Tax Law Review* 3 (2008), p. 142 et seq.

149. See ECJ, 5 July 2007, Case C-321/05, *Hans Markus Kofoed v. Skatteministeriet*, Para. 38 on the abuse provision in Art. 11 of the Merger Directive (Directive 90/434/EC). O. Rousselle and H.M. Liebman, "The Doctrine of the Abuse of Community Law: The Sword of Damocles Hanging over the Head of EC Corporate Tax Law?", *European Taxation* 12 (2006), p. 559 et seq., state that the *Halifax* decision does not add further adjustment possibilities to the existing tax law directives, as all the directives already contain fraud and abuse provisions that allow the Member States to refuse the taxpayers the benefits granted by the directives. See, in general, regarding abuse under EU law, E. Sørensen, "Abuse of Rights in Community Law: A Principle of Substance or Merely Rhetoric?", *Common Market Law Review* 2 (2006), p. 423 et seq.

150. See, regarding the ECJ abuse doctrine, for example, Sørensen, note 149, p. 423 et seq.; L. De Broe, *International Tax Planning and Prevention of Abuse* (Amsterdam: IBFD, 2008), p. 799 et seq.; M. Dahlberg, *Direct Taxation in Relation to the Freedom of Establishment and the Free Movement of Capital* (London: Kluwer Law International, 2005), p. 223 et seq.

151. See, for example, *Lankhorst-Hohorst*, note 52.

152. See, for example, ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue,* Para. 51 with references.

153. See, for commentary, M. Lang, "Rechtsmissbrauch und Gemeinschaftsrecht im Lichte von Halifax und Cadbury Schweppes", *Steuer und Wirtschaft International* 6 (2006), p. 273 et seq., analysing the *Cadbury Schweppes* case as well as the *Halifax* case, and T. O'Shea, "The UK's F rules and the freedom of establishment: Cadbury Schweppes plc and its IFSC subsidiaries – tax avoidance or tax mitigation?", *EC Tax Review* 1 (2007), p. 13 et seq.

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> arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.[154]

It is interesting to note which criteria the ECJ applied to test the existence of a "wholly artificial arrangement that does not reflect economic reality". The ECJ has stated that this assessment contains both objective and subjective elements. The subjective element requires a demonstration of the intent of the taxpayer to obtain a tax saving. The objective factors are:

> [...] ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment."[155]

Further, the ECJ stated:

> If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a 'letterbox' or 'front' subsidiary [...].

More recently, the ECJ provided further clarification regarding the tax avoidance test in *Test Claimants in the Thin Cap Group Litigation*. The ECJ concluded that Art. 43 of the EC Treaty (now Art. 49 of the Treaty on the Functioning of the European Union – TFEU) precludes thin capitalization legislation resulting in an interest deduction restriction on loans from parent companies in other Member States, unless (1) the legislation provides for a consideration of objective and verifiable elements that make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, and allows taxpayers to produce evidence as to the commercial justification for the transaction in question, and (2) where it is established that such an arrangement exists, such legislation treats that interest as a distribution only so far as it exceeds what would have been agreed upon at arm's length.[156]

In the context of HFIs, and based on the above, purposes for the transaction other than saving tax should be demonstrated. When financing is needed, such a requirement can be fulfilled since the nature of the financing (equity, debt or hybrid) should not result in the transaction generally being considered abusive.

In the following, the author reviews cross-border arbitrage in light of ECJ case law regarding tax abuse. The analysis does not take a position on the overall compatibility of the different anti-arbitrage provisions with the fundamental freedoms contained under primary EU law, but assesses whether or not the Parent-Subsidiary Directive benefits can be rejected as a consequence of tax arbitrage.[157]

#### 4.2.1.2. Tax motives

Tax arbitrage constitutes a specific form of tax saving based on classification and legislative differences amongst Member States. In general, the ECJ has held that tax saving motives alone do not constitute abuse if the transaction or establishment in question reflects economic reality. In *Cadbury Schweppes* the ECJ further stated that a restriction on the freedom of establishment cannot be justified when, despite the existence of tax motives, the incorporation of a controlled foreign company (CFC) reflects economic reality. That incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State.[158]

In the context of HFIs and tax arbitrage, it is assumed that the use of the instruments does, in fact, reflect economic reality and that the tax advantage obtained is merely a consequence of differences in the legislation or classification principles applied between the Member States involved. Consequently, tax arbitrage cannot be seen as an abusive practice that is excluded from the scope of the directives.

Moreover, it is settled case law that the domestic tax legislation in the state of origin cannot maintain requirements as regards the level of taxation in the host state in order to prevent tax jurisdiction shopping. Such practices do not, in themselves, constitute abuse as long as they do not involve the setting up of wholly artificial arrangements.[159] This is evident in a number of ECJ cases.[160] In the absence of a wholly artificial arrangement, Member States must recognize each other's tax systems regardless of how different they may be.[161] It is arguable that the deductibility of dividends or of payments that are classified inconsistently due to the application of different principles of domestic tax legislation of the Member States stems from the deviations that may have caused a company to be considered a low-tax company under the applicable CFC legislation of many Member States. Thus, at the end of the day, CFC taxation of foreign low-taxed companies and the denial of directive benefits for dividend payments from foreign companies on the basis that the payments are deductible are two sides of the same coin.

Further, it may be argued that the anti-arbitrage legislation actually – as was also the situation in the *Cadbury Schweppes* case – ensures taxation of the corporate income in question at the level of the home state.

As stated by the ECJ in *Cadbury Schweppes*, such domestic practices can only be upheld if they actually prevent tax abuse and tax abuse alone. As discussed in 4.2.1.1. many HFIs used for tax arbitrage purposes should not face a great deal of difficulty in passing that test, as they

154. See *Cadbury Schweppes*, note 152, Para. 55.
155. Id., Para. 67.
156. See ECJ, Case C-524/04, 13 March 2007, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, Para. 92.
157. The use of the principle of correspondence (*Korrespondenzprinzip*) under EU law has been questioned in the German tax literature. See, for example, Dörfler, Heurung and Adrian, note 144, p. 517 et seq.
158. See *Cadbury Schweppes*, note 152, Para. 65 et seq.
159. See De Broe, note 148, p. 146.
160. See ECJ, 15 July 2004, Case C-315/03, *Anneliese Lenz v. Finanzlandesdirektion für Tirol*; ECJ, 26 October 1999, Case C-294/97, *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna*; ECJ, 3 October 2002, Case C-136/00, *Rolf Dieter Danner*; ECJ, 26 June 2003, Case C-422/01, *Försäkringsaktiebolaget Skandia (publ) and Ola Ramstedt v. Riksskatteverket*; and *Cadbury Schweppes*, note 152.
161. See De Broe, note 148, p. 146.

serve the underlying purpose of providing the financing needed in order to fulfil business purposes.

The VAT decision in the *Halifax* case concerned a VAT-exempt bank (subject to a 5% VAT deduction), which let its relevant transactions pass through a fully taxable subsidiary to obtain a full VAT deduction. The ECJ concluded that a VAT refund cannot be allowed under the Sixth VAT Directive (77/338/EEC) when the underlying transaction constitutes an abusive practice. The finding of an *abusive practice* first requires that the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth VAT Directive and of domestic legislation transposing it, result in the accrual of a tax advantage, the granting of which would be contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage.[162] Tax authorities in several Member States have interpreted the *Halifax* decision widely, applying the decision also in regard to direct taxes.[163] In *Part Service Srl.,* the Italian Supreme Court submitted the following question to the ECJ with respect to the interpretation of the Sixth VAT Directive:

> Does the concept of abuse of rights defined in the judgment of the Court of Justice in [Halifax and Others] as *transactions, the essential aim of which is to obtain a tax advantage*, correspond to the definition *transactions carried out for no commercial reasons other than a tax advantage*, or is it broader or more restrictive than that definition?[164]

The ECJ confirmed that the Sixth VAT Directive should be interpreted as meaning that there can be a finding of an abusive practice when the accrual of a tax advantage constitutes the principal aim of the transaction or transactions at issue.

In the context of HFIs, this may affect some structures predominantly established for tax purposes. However, in many situations HFIs would not fulfil this test, since the underlying transaction would, in fact, take place irrespective of the tax treatment, albeit likely in the form of ordinary debt or equity. The same cannot be said with respect to the transactions in *Part Service*, which seem to have been carried out predominantly for VAT purposes. Therefore, in the author's opinion, tax arbitrage should not, on this basis either, be considered abusive in the context of interpreting the TFEU and the Parent-Subsidiary Directive.

#### *4.2.1.3. Should double-dip arrangements be considered abusive?*

In international tax arbitrage the idea is simply to utilize the differences between the domestic tax legislation of different countries. Such an approach seems perfectly acceptable according to the *Cadbury Schweppes* judgment. However, as stated by the ECJ in Para. 47 of *Marks & Spencer*, it is acceptable for Member States to prevent losses from being used twice (if group relief is allowed). In the actual case such a danger was deemed to exist in circumstances where group relief is extended to the losses of non-resident subsidiaries. The ECJ concluded that the UK legislation pursued legitimate objectives that are compatible with the treaty and constitute overriding reasons in the public interest and that they were apt to ensure the attainment of those objectives.[165] The risk of a double loss deduction (double dip) was, however, not decisive on its own, but was to be considered together with the risk of tax avoidance (see Para. 49: transferring losses to companies resident in Member States with the highest rates of taxation) and preservation of the right to impose taxes between the Member States (see Paras. 45-46).[166] To give companies the option of having their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardize a balanced allocation of the power to impose taxes between Member States, as the tax base would be increased in the first state and reduced in the second to the extent of the losses transferred.

Based on this, the ECJ is clearly aware of the negative consequences of double dipping. Thus, it is arguable that this conclusion could influence the EU law analysis of national anti-arbitrage provisions that restrict directive benefits if the result would otherwise be a double benefit to the taxpayer.[167] Double dip and double non-taxation

162. See ECJ, 21 February 2006, Case 255/02, *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v. Commissioners of Customs & Excise, BUPA Hospitals Ltd, Goldsborough Developments Ltd v. Commissioners of Customs and Excise and University of Huddersfield Higher Education Corporation v. Commissioners of Customs and Excise plc.*, Para. 85 et seq. The outcome of the case is in line with established case law, according to which EU law cannot be relied on in cases of abuse or fraud; see, for example, ECJ, 12 May 1998, Case C-367/96 *Alexandros Kefalas and Others v. Elliniko Dimosio (Greek State) and Organismos Oikonomikis Anasygkrotisis Epicheiriseon AE (OAE)*, Para. 20; ECJ, 28 October 1999, Case C-373/97, *Dionysios Diamantis v. Elliniko Dimosio and Others*, Para. 33; and ECJ, 3 March 2005, Case C-32/03, *I/S Fini H v. Skatteministeriet*, Para. 32. In the *Halifax* case, however, the Court found it completely irrelevant for the interpretation of the Sixth VAT Directive whether or not the main objective of the transaction was to obtain tax benefits (see Para. 59 of the case).

163. See L. Sheppard, *World Tax Daily* (2007) 25-8, p. 5; for Italian law, see M. Rossi, *World Tax Daily* (2007) 58-9, p. 20 referring to two rulings where Italian courts have disregarded certain transactions arranged to avoid direct taxes with reference to the *Halifax* decision; and, for French law, see L. Leclercq, "Interacting principles: the French abuse of law concept and the EU notion of abusive practices", *Bulletin for International Taxation* 6 (2007), p. 235 et seq.

164. ECJ, 21 February 2008, Case C-425/06, *Part Service, Ministero dell'Economia e delle Finanze, formerly Ministero delle Finanze v. Part Service Srl, company in liquidation, formerly Italservice Srl.*, Para.1 of the reference.

165. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes,* Para. 51. See M. Lang, "Direct Taxation: Is the ECJ Heading in a New Direction", *European Taxation* 9 (2006), p. 426 regarding the justification. Lang finds the ECJ's reasoning in line with ECJ, 12 July 2005, Case C-403/03, *Egon Schempp v. Finanzamt München V*. The author, however, finds it unconvincing that the ECJ places so much emphasis on the avoidance of double non-taxation in an EU tax framework in which the tax base is not harmonized and, therefore, some of the income of a taxpayer could easily be taxed twice or not at all.

166. See ECJ, Advocate General Kokott's Opinion, 12 September 2006, Case C-231/05, *Oy AA*, Para. 48, in which it is stated that all three elements should be taken together and cannot be viewed on a separate basis; the essential part is the preservation of the right to impose taxes between the Member States. Lang, see note 165, finds that the "taken together" view on different grounds of justification has caused uncertainty.

167. See, for example T. Rønfeldt, "Marks & Spencer – en fællesskabsretlig håndsrækning", *Skattepolitisk Oversigt* 2 (2006), p. 11 et seq. and T. Rønfeldt, "Marks & Spencer – Community Law Extends a Helping Hand", *European Business Law Review* 6 (2006); p. 1715 et seq., arguing that the prevention of double dipping is now a legitimate ground to justify domestic tax legislation aimed at preventing exactly that. See, however, for a more reluctant interpretation of the *Marks & Spencer* decision, Lang, note 165, p. 426.

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or deduction/non-inclusion are closely related outcomes of tax planning techniques. However, it may be argued that the ECJ would not uphold the argument in cases regarding anti-arbitrage provisions, since the aim of the legislation in question and the group relief legislation in the United Kingdom in the *Marks & Spencer* case are not comparable. The anti-arbitrage legislation aims at eliminating taxpayer benefits arising from different domestic tax legislation whereas the group relief aims at providing the possibility for taxpayers to utilize group losses in other group companies. Second, it appears from the *Marks & Spencer* decision that tax abuse and tax arbitrage are not considered one and the same. Third, the risk of double dips did not fall under the heading of abuse in the *Marks & Spencer* case but rather served as a separate justification from the Member State's perspective (double dips may, however, also be considered a subset of the tax abuse justification). Thus, there is little support in favour of an interpretation that considers tax arbitrage abusive in the context of the Parent-Subsidiary Directive.

From the *Oy AA* decision it is apparent that the ECJ interprets the notion of double utilization of losses narrowly, i.e. as not including anything other than losses.[168] Such a narrow interpretation may also limit the use of the argument in cases concerning HFIs.

Moreover, the ECJ has accepted that (juridical) double taxation occurs as a consequence of a lack of harmonization and the application of different tax legislation in different Member States. This was, in essence, the result in *Kerckhaert & Morres*, where the ECJ accepted Belgian legislation concerning inbound dividends for individuals according to which domestic dividends were taxed at the same rate as foreign dividends without taking foreign withholding taxes into consideration (i.e. no credit relief was provided). Para. 20 of the decision is particularly interesting in this context. Here the ECJ stated that any negative consequence of the Belgian tax system at stake is a result of the parallel exercise of fiscal sovereignty of two Member States.[169] This reasoning must work both ways to the benefit of Member States and to the benefit of taxpayers.

Based on the above, it is submitted that a tax advantage arising as a consequence of a different classification of HFIs between Member States should not per se be considered abusive.[170] Accordingly, directive benefits cannot be denied by Member States simply by referring to a tax advantage obtained by the taxpayers.

#### 4.2.2. *Denial of directive benefits due to a difference in classification and/or deductibility in the source state*

In the unilateral models presented, the provisions result in a reduction in the scope of application of the Parent-Subsidiary Directive since directive benefits are not granted in regard to dividends payments received by a parent company if the payment gives rise to a deduction in the state of the paying company. In this section, the author analyses the limitations on Member States with respect to combating tax arbitrage where such cross-border tax arbitrage is not considered abusive. An analysis of the acceptability of such measures depends on the interpretative method applied. Two main arguments are in favour of such unilateral measures.

First, it should be stated that tax arbitrage transactions result in real tax benefits for taxpayers by way of double non-taxation or deduction that is not followed by a corresponding inclusion. Based on this, it may be argued that a limitation on the application of the Parent-Subsidiary Directive by the state of residence of a parent company does not violate the objective of the Parent-Subsidiary Directive, since no double taxation will occur as a consequence of such a domestic response. In fact, the domestic provisions uphold the principle of single taxation.

Second, it should be noted that a Member State of a parent company that reclassifies a payment from an equity instrument as taxable interest or, in general, reclassifies the instrument from equity to debt is simply aligning the domestic treatment of the instrument in question with the classification of the source state.[171] As stated in 3.3., such a result seems to be supported in theory.

On the other hand, it can be argued that a unilateral limitation on the applicability of the Parent-Subsidiary Directive, depending on deductibility in the source state is, in substance, similar to the situation where directive benefits are denied if certain tax exemptions regarding specific types of income result in low or zero taxation of the subsidiary. A denial of directive benefits in such a scenario does not seem to be in accordance with the "subject to" tax clause in Art. 2(1)(c) of the Parent-Subsidiary Directive according to which the company

168. See *Oy AA*, note 166, Para. 57.

169. *Kerckhaert & Morres*, see note 40. See also ECJ, 6 December 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt*, Para. 43 and ECJ, 1 October 2009, Case C-247/08, *Gaz de France – Berliner Investissement SA v. Bundeszentralamt für Steuern*, Para. 47. For commentary see, for example, L. Ceroni, "Double Taxation and the Internal Market: Reflections on the ECJ's Decisions in *Block* and *Damseaux* and the Potential Implications", *Bulletin for International Taxation* 11 (2009), p. 543 et seq.

170. De Broe, see note 148, p. 146, correctly concludes that a mismatch does not, in itself, constitute an abusive tax practice if the terms of the HFI are at arm's length and the instrument satisfies a genuine financial need of the borrower. The author, however, notes that the ECJ is not indifferent towards double non-taxation. The author also analyses the question of compensatory taxation and prevention of double non-taxation in his thesis *International Tax Planning and Prevention of Abuse: A Study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies* (Amsterdam: IBFD, 2008), p. 915 et seq., at p. 921, where it is concluded that tax jurisdiction shopping is only illegitimate if the taxpayer has set up a wholly artificial arrangement with no other purpose than to avoid taxation. In that case compensatory taxation is permitted in the view of the author. See moreover, D. Weber, *Tax Avoidance and the EC Treaty Freedoms – A Study of the Limitations under European Law to the Prevention of Tax Avoidance* (The Hague: Kluwer Law International, 2005), p. 210 et seq. Under the heading "Making Use of Disparities in Tax Cases", the author concludes that abusive tax avoidance does not exist merely because a taxpayer is subject to an (advantageous) tax system in another Member State.

171. The argument is not valid with respect to the Notional Interest Deduction (NID) rules in Belgium, which maintain the equity classification of the instruments in Belgium, but allow a deduction on equity. Thus, in regard to dividends received from Belgian companies, the state of residence of the receiving company does not just bring the classification in line with that of the source state.

should be: "subject to one of the following taxes, without the possibility of an option or of being exempt." It is clear that the subject to tax clause does not, in itself, prevent tax arbitrage. Thus, dividend deductibility, equity deductibility (Belgium) or debt classification does not imply that the subsidiary is not subject to company tax in the source state. Although the deduction reduces the overall tax liability, it does not constitute an exemption from company tax.

In conclusion, it is the author's opinion that the scope of the Parent-Subsidiary Directive cannot be reduced on the basis of deductibility of the yield in the Member State of the paying company. Since the ECJ is not likely to apply a teleological interpretation to reduce the scope of the Directive, a literal interpretation should prevail in this context. A reduction of the scope of the Directive should be based on specific provisions in the Directive allowing for this. The only option is to apply the fraud and abuse provision in Art. 1(2) of the Parent-Subsidiary Directive. However, tax arbitrage does not, as a general rule, constitute an abusive practice.

## 5. Fulfilment of the Holding Requirement by HFIs

In order to fulfil the requirement of association between the companies set out in Art. 4 of the Parent-Subsidiary Directive, Art. 3(1)(a) requires a minimum holding of 10% in the capital of a company of another Member State. In Art. 3(b) (i)-(iii), the Interest and Royalties Directive requires a direct minimum holding of 25% of the capital in order for the benefits of the Directive to be granted. The question of whether or not the holding requirement can be fulfilled by HFIs not formally considered equity under the Parent-Subsidiary Directive and Interest and Royalties Directive should be answered in the same manner. Accordingly, the analysis below applies to both directives.

The holding requirement in the Parent-Subsidiary Directive and the Interest and Royalties Directive refers to the holding of share capital and, accordingly, covers the holding of equity capital of a subsidiary.[172] With respect to HFIs, Helminen concludes as follows:

> […] Further, if hybrid debt is treated as equity, hybrid debt should also be taken into account in calculating the fulfilment of the holding requirement between two companies for the purposes of the P-S Directive. P-S Directive benefits should be granted even though only the constructive equity would bring the holding to the level required […]"[173]

Moreover, the author states that there is no reason why the term "association" could not also cover constructive equity capital.[174] Based on this it is stated that income from hybrid debt that is actually equity by nature should also qualify under the Parent-Subsidiary Directive.[175]

This conclusion is seemingly based on the assumption that hybrid debt is either fully debt or fully equity, which is hardly the case in practice. Moreover, it is uncertain which principles of classification should apply to the assessment in order to reveal the "true" nature of the HFI in question. Finally, the conclusion does not take into consideration that in some states the debt/equity reclassification is actually just a matter of reclassifying the yield on hybrid financial instruments (from interest to dividends) rather than reclassifying the instrument itself, with all the accompanying effects of such a full reclassification. Therefore, the conclusion should necessarily be modified in the author's point of view.

As is correctly mentioned by Helminen, Para. 15 of the Commentary to Art. 10(2) of the OECD Model supports her interpretation.[176] The OECD Model uses the following wording: "holds directly at least 25 percent of the capital of the company paying the dividends". In the OECD Commentary this is interpreted as follows:

> 15. In subparagraph a) of paragraph 2, the term "capital" is used in relation to the taxation treatment of dividends, i.e. distributions of profits to shareholders. The use of this term in this context implies that, for the purposes of subparagraph a), it should be used in the sense in which it is used for the purposes of distribution to the shareholder (in the particular case, the parent company).
>
> a) As a general rule, therefore, the term "capital" in subparagraph a) should be understood as it is understood in company law. Other elements, in particular the reserves, are not to be taken into account.
>
> […]
>
> d) When a loan or other contribution to the company does not, strictly speaking, come as capital under company law but when on the basis of internal law or practice ("thin capitalization", or assimilation of a loan to share capital), the income derived in respect thereof is treated as dividend under Article 10, the value of such loan or contribution is also to be taken as "capital" within the meaning of subparagraph a).

It is, therefore, apparent that, according to the OECD Commentary, there is also room for certain HFIs to qualify as capital in this context.[177] In the author's opinion, the OECD Commentary cannot, however, be expected to influence the interpretation of the Parent-Subsidiary Directive.[178] This is based on at least two arguments: (1) the OECD Model and EU law are different legal systems; and (2) the OECD Commentary does not specifically address HFIs but rather seems to refer to shareholder loans that are reclassified in the source state.

Moreover, it should be considered whether or not the Parent-Subsidiary Directive should be interpreted in

172. See ECJ, 22 December 2008, Case C-48/07, *Les Vergers du Vieux Tauves SA v. État belge – Service public fédéral Finances SA*, Para. 33 et seq., and Helminen, note 44, p. 267. In support, see Eberhartinger and Six, note 25 p. 226. Vanistendael, see note 118, p. 154, interprets the requirement as meaning that there must be a share of the outstanding capital in the sense of company law.

173. See Helminen, note 44, p. 267. The same conclusion is made at p. 282 regarding perpetual debt, at p. 291 regarding Profit-Participating Debt Instruments, at p. 301 regarding convertible bonds, at p. 309 regarding subordinated debt instruments and at p. 316 regarding preference shares.

174. See Helminen, note 44.

175. Id.

176. Id., p. 267.

177. See, regarding the term "capital", K. Vogel, *Doppelbesteuerungsabkommen der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkommen und Vermögen* (Munich: Beck, 2008), Kommentar auf der Grundlage der Musterabkommen, p. 867, marginal notes 57-58.

178. See, for example, Brokelind, note 46, p. 327, wherein he states that it is doubtful that the ECJ would subject the application of a directive to the application of a concept in a tax treaty, unless this was provided for in the directive itself.



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line with the Merger Directive (1990/434/EEC). Art. 2(d) of the Merger Directive makes similar use of the notion of "holding in the capital" with respect to the exchange of shares under the transaction covered by the Directive. According to the tax literature, this notion is to be interpreted as purely formal, referring to private law ownership of the capital in the receiving company that provides the majority of the voting rights in this company.[179] If this interpretation of the Merger Directive is correct, and, moreover, it can be argued that it also applies to the Parent-Subsidiary Directive, the latter may similarly be said to refer only to formally existing (under private law) capital holdings of another company. One important issue should, however, be highlighted with regard to a comparison between the two directives. Arguing that the requirement under the Merger Directive is purely formal ensures the objective of the Merger Directive is attained and reduces the possibility for Member States to limit the scope of the directive to holdings in the capital of another company that include voting powers of a certain quality in that company. This situation is not comparable to that of the Parent-Subsidiary Directive. Thus, when analyzing the scope of the Parent-Subsidiary Directive, an argument that only purely formal holdings in the capital would qualify for the benefits of the Directive would, in fact, reduce the scope of application of the Directive and thus, in some cases, would lead to double taxation, which would be contrary to the objective of the Directive. In other words, a literal interpretation of the Merger Directive results in a broad interpretation of that Directive, whereas the same line of interpretation in regard to the Parent-Subsidiary Directive would lead to a narrow interpretation. Such a difference may be significant in light of the fact that the ECJ favours interpretations of EU directives that ensure the objective of the directive in question.

The ECJ decision in *Les Vergers du Vieux Tauves SA*, has shed some light on the scope of the Parent-Subsidiary Directive. The referring court, in essence, asked whether or not the concept of a holding in the capital of a company of another Member State, within the meaning of the Parent-Subsidiary Directive, includes the holding of shares in usufruct.[180] The ECJ first compared the status of the usufruct holder to the legal status of a shareholder and concluded in Para. 33 that:

> […] as VVT is not the owner of the shares in NARDA, its legal relationship [with] NARDA is not derived from any status as a shareholder, but is inferred from the right of usufruct held by VVT […].

Based on this, the ECJ went on to analyse whether or not the usufructuary of the shares of a company can also be regarded as a parent company within the meaning of Art. 3 of the Parent-Subsidiary Directive. In answering this, the ECJ derived from Art. 3(1)(b) that the concept of "holding in the capital" within the meaning of Art. 3 refers back to the legal relationship between the parent company and the subsidiary (Para. 38). Accordingly, it follows from the wording of Art. 3 that the concept does not cover a situation in which the parent company transfers to a third party a legal relationship with the subsidiary under which that third party might be regarded as a parent company (Para. 38). In conclusion the ECJ, therefore, states the following in Para. 44:

> Accordingly, in the light of the clear and unambiguous wording of the provisions of Directive 90/435, as confirmed by the purpose thereof, it is not possible to interpret the concept of a holding in the capital of a company of another Member State, set out in Article 3 of that directive, as covering the holding, in usufruct, of shares in the capital of a company of another Member State and as thereby increasing the obligations of the relevant Member States (see by way of analogy, Case C-220/03 BCE v Germany [2005] ECR I-10595, paragraph 31, and Case C-263/06 Carboni e derivati [2008] ECR I-1077, paragraph 48[…].

This decision clearly interprets the holding requirement in a strict and narrow sense that only includes formal holdings of the capital of a subsidiary. This has been called a civil law approach of the ECJ.[181]

The interpretation of the ECJ is literal and not teleological, as one would have expected in light of previous ECJ case law.[182] However, as pointed out by Peeters and Van de Vijver, when analysing previous decisions in more detail, a hierarchy is seen in the interpretation methods.[183] Previous case law may be seen as employing a two-stage approach that involves first applying a literal approach and then a teleological approach if the literal approach is sufficiently broad.[184] In light of this, the ECJ's decision in *Les Vergers du Vieux Tauves SA* is not surprising, since the literal interpretation leaves no room for a teleological approach.[185] Peeters and Van de Vijver find that a literal interpretation of the usufruct as a right in rem would open the door to a teleological interpretation, while still remaining within the wording of the Directive.[186] However, based on a teleological interpretation, uncertainty also remains. Some Member States have argued that a usufructuary cannot be deemed to have a holding in the capital, since the usufructuary does not have all the rights conferred on an ordinary shareholder.

179. See, in general, on the interpretation of the Merger Directive regarding this issue, Thömmes et al., note 70, Chapter 5, regarding Art. 2, No. 57 et seq. In the Danish commentary it was stated by Serup, note 131, p. 641 et seq. that the notion is evident and does not leave room for uncertainty. Serup stated that the notion is purely formal and there are no requirements other than private law ownership requirements. In a Danish High Court case referred to in TfS 2003, 355 Ø, the ownership requirement was, however, interpreted in accordance with a substance-over-form approach, disqualifying the transaction in question from the application of the provision regarding a tax-neutral exchange of shares.
180. See *Les Vergers du Vieux Tauves SA*, note 172. The case concerned the right of a Belgian usufruct holder to enjoy the benefits of the Parent-Subsidiary Directive. Usufruct is defined in Art. 578 of the Belgian Civil Code as the right to enjoy things owned by another, including the dividends of the shares in question.
181. See F. Switala, "Withholding Tax Exemption and Right to Usufruct Shares in a Subsidiary Company", *European Taxation* 6 (2009), p. 337 et seq. and B. Peeters and A. Van de Vijver, "ECJ Rules on Compatibility of Belgian Participation Exemption Regime with EC Parent-Subsidiary Directive", *EC Tax Review* 4 (2009), p. 146, at p. 149.
182. See Peeters and Van de Vijver, note 181, p. 149.
183. Id.
184. Id. This pattern was also followed by the ECJ in the recent *Gaz de France* case (see note 169).
185. Advocate General Sharpston's reached the opposite conclusion, considering the usufruct a holding in the capital based on the overall scheme and objective of the Parent-Subsidiary Directive. See Advocate General Sharpston's Opinion, note 85, Para. 58 et seq.
186. See Peeters and Van de Vijver, note 181, p. 150.

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On the other hand, Advocate General Sharpston argued that the purpose of the Directive is only realized when the usufructuary is entitled to invoke the Directive.

Switala argues that the ECJ should have put more emphasis on the objective of the Directive.[187] He, moreover, criticizes the idea that an arrangement can give rise to dividend withholding tax without even being considered a shareholder relationship. Finally, the author favours the result of a recent Polish case decided by the Lublin District Administrative Court on 19 December 2008 wherein a usufruct holder was, in fact, considered eligible for the benefits of the Parent-Subsidiary Directive, as the Directive, in the Court's view, should take into account who the holder of the shares is and not who the owner is.[188]

Peeters and Van de Vijver are also sceptical of the decision; they are of the view that the question should be answered by taking into account the purpose of the Directive.[189] Moreover, the authors question the understanding of the ECJ regarding the nature of the usufruct. Thus, the authors argue that the usufruct is a right in rem, pursuant to which the usufructuary exercises its rights without the intervention of the legal owner. Accordingly, in the view of the authors, one may argue that the rights conferred on the usufructuary may lead to the right of usufruct being characterized as a holding in the capital and that Art. 3 of the Directive does not require that all attributes of shareholder status be present.[190]

The effect of this decision with respect to HFIs that are, in economic substance, considered equity may be significant, since such HFIs (i.e. hybrid debt) also do not reflect formal equity of a company. However, there is one important difference between the usufruct and the HFI situations. In most cases where HFIs are used, a shareholder relationship has already been established, and the question simply is whether or not the HFI in place can increase the holding in the capital above the required holding percentage. Moreover, the ECJ's reliance on Art. 4(2) of the Directive regarding losses in the context of acquiring the shares of the subsidiary is not relevant in the context of HFIs if it is existing shareholders (for example, the 100% parent company) that are granting the HFI capital to a company (the subsidiary).

In conclusion, it is submitted that HFIs do not constitute equity capital under the directives, as they do not fulfil the holding requirements of the directives. As a consequence, this may result in a situation where yield from HFIs will not be considered income from shares if there is no shareholder relationship.

## 6. Applicability of the Arbitration Convention to the Classification of Hybrid Financial Instruments

The Arbitration Convention applies to double taxation arising as a consequence of transfer pricing adjustments.[191] Generally, it does not apply to double taxation arising as a consequence of different classifications of income.[192] In many countries, thin capitalization provisions reclassify the financing of a company, for example, the debtor state may classify debt as equity, whereas the creditor state may classify the financing as debt. Thus, thin capitalization provisions do not address the terms and conditions of a transaction but rather reclassify the transaction itself.[193] It is, however, recognized in Para. 1 of the Commentary to Art. 9(1) of the OECD Model that thin capitalization can be seen as a part of the arm's length principle. Based on the similarity of the wording of Art. 9 of the OECD Model and Art. 4 of the Arbitration Convention, it can be argued that the Convention should also apply in cases of thin capitalization.[194] A similar broad interpretation was advocated in the Final Report of the EU Joint Transfer Pricing Forum (JTPF) on the Interpretation of some Provisions of the Arbitration Convention; thin capitalization adjustments, in the view of JTPF, should be included within the scope of the Arbitration Convention.[195]

Based on the above, it has also been argued that the Arbitration Convention is applicable in situations of double taxation arising as a consequence of inconsistent classification of HFIs. Helminen concludes that the procedures of the Arbitration Convention should also be applied to eliminate double taxation due to classification conflicts with respect to hybrid debt.[196] The reasoning is that, according to the Commentary, Art. 9 of the OECD Model is applicable with respect to analysing whether or

187. See Switala, note 181, p. 337 et seq.
188. Case I SA/Lu593/08.
189. See Peeters and Van de Vijver, note 181, p. 146 et seq.
190. Id., p. 149. Finally, the authors submit that the fact that the ECJ finds confirmation for the decision in Art. 4(2) of the Directive does not appear to be correct. The authors correctly state that one cannot conclude from Art. 4(2) of the Parent-Subsidiary Directive that the scope of application of the entire Directive is limited to situations where the person receiving a profit distribution is also the person suffering a possible loss resulting from that profit distribution. Art. 4(2) of the Parent-Subsidiary Directive only provides that if such loss occurs, Member States remain competent to provide that it is not tax deductible; see id., p. 150.
191. Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (90/436/EEC).
192. See, to this effect, J. Wittendorff in J. Bundgaard and J. Wittendorff, eds., *Armslængeprincippet & Transfer Pricing* (Copenhagen: Magnus Informatik, 2000), p. 281.
193. See L. Hinnekens, "The Arbitration Convention. Its significance for the EC based enterprise, the EC itself, and for Belgian and International tax law", *EC Tax Review* 2 (1992), p. 90; D. Schelpe, "The Arbitration convention: its origin, its opportunities and its weaknesses, *EC Tax Review* 2 (1995), p. 76 et seq.; and R. A. Sommerhalder, "Approaches to Thin Capitalization", *European Taxation* 3 (1996), p. 82.
194. See Para. 2 of the Commentary to Art. 9 of the OECD Model, the OECD report "Thin Capitalisation" 1986 and the OECD Transfer Pricing Guidelines, Paras. 1.37-1.38. Strong arguments have been presented against such an interpretation; see J. Wittendorff, "The Transactional Ghost of Article 9(1) of the OECD Model", *Bulletin for International Taxation* 3 (2009), p. 107 et seq., arguing that Art. 9(1) is concerned only with genuine transfer pricing adjustments and that transactional adjustments are outside the scope of the OECD Model. Thin capitalization issues are specifically analysed at p. 119 et seq., where the author refers to the existing vast literature on the subject in footnotes 134 and 135.
195. See COM 2009(472) final, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the period March 2007 to March 2009 and a related proposal for a revised Code of Conduct for the effective implementation of the Arbitration Convention (90/436/EEC of 23 July 1990), p. 6, Para. 18 et seq.
196. See Helminen, note 44, p. 269.

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not a prima facie loan may be regarded as a loan or should be regarded as some other kind of payment, in particular, a contribution to equity capital.[197] The author, however, recognizes that such a broad interpretation is not generally accepted. Helminen is correct in stating that arguments may be presented in favour of applying the Arbitration Convention in cases of thin capitalization where excessive interest payments have been reclassified as dividends. However, this issue has not yet been clarified.

The objective of the Arbitration Convention is clearly to eliminate double taxation arising as a consequence of the simultaneous application of different Member States' transfer pricing legislation.[198] The use of the arm's length principle is contained in Art 4. It is unlikely that the classification of HFIs can be dealt with under domestic transfer pricing legislation. As such, the author finds it troubling to conclude that this issue would be covered by the Arbitration Convention. Basically, the classification of HFIs is a radically different issue than the application of the arm's length principle to financial transactions, which, in regard to thin capitalization provisions in some countries, results in a reclassification of debt as equity. Clearly, a financial debt instrument becomes hybrid, in some sense, when it is considered debt in the state of the creditor and reclassified as equity in the state of the debtor due to excessive debt financing. Such financial instruments do not, however, fall within the scope of this article.

Based on this, it is submitted that the Arbitration Convention does not apply to the classification of HFIs.

197. Para. 3(b) of the Commentary to Art. 9 of the OECD Model.
198. See Art. 1(1): This Convention shall apply where, for the purposes of taxation, profits which are included in the profits of an enterprise of a Contracting State are also included or are also likely to be included in the profits of an enterprise of another Contracting State on the grounds that the principles set out in Article 4 and applied either directly or in corresponding provisions of the law of the State concerned have not been observed.

## 7. Conclusions

As the use of HFIs in European corporate finance practice has increased, there is a need for certainty and clarity with respect to the tax law classification and treatment of the instruments and the yield thereon. The article has sought improvements in this respect. However, it is not possible to provide absolute legal certainty *de lege lata* in this regard. A number of different issues that may arise in the area of cross-border HFIs within the European Union were analysed separately.

First, whether or not yield from hybrid debt instruments (equity-like debt instruments) may benefit from the Interest and Royalties Directive was examined. It was found that the scope of the Interest and Royalties Directive with respect to HFIs is specifically addressed in Art. 4 of the Interest and Royalties Directive. However, uncertainty regarding the correct interpretation remains in regard to determining whether or not the actual scope of the Directive encompasses different types of HFIs.

Second, the article analysed whether or not yield from hybrid equity instruments (debt-like instruments) may benefit from the Parent-Subsidiary Directive. If the directives do not apply, double taxation may occur in some situations. A precise definition of the notion of "distribution of profits" in the Parent-Subsidiary Directive is absent. Accordingly, uncertainty exists with respect to the definition and, even more so, with respect to the application of the Parent-Subsidiary Directive to HFI yield. As is apparent from the analysis, an autonomous interpretation of the notion of a distribution of profits is widely accepted among commentators, albeit in varying degrees. Although autonomy is the starting point there seems to be room for national deviations with respect to the content of the notion of dividends. Moreover, it is argued that a legal definition should not be replaced by a vague reference to the economic nature of the payment at hand. However, clear guidelines are not available. It could be argued that any tax is covered and that any "distribution" is covered by the Parent-Subsidiary Directive, including yield from HFIs that are equity-like and thus produce dividend-like yield if considered equity/dividends in the source state. The points of view presented provide some further arguments in favour of applying the Parent-Subsidiary Directive in cases of concealed dividend payments, which should also affect the treatment of HFIs. In sum, it is submitted that sound arguments exist for including the yield from HFIs within the scope of the Parent-Subsidiary Directive. This conclusion relies on a teleological interpretation of the Directive. Moreover, the analysis shows that a literal interpretation does not exclude the yield at hand, which should then open the door to a teleological interpretation of the Parent-Subsidiary Directive.

Third, the article analysed whether classification inconsistencies can arise irrespective of the existence of the directives or whether the Member States are obliged to classify HFIs and the yield from such instruments in a consistent manner under the directives. This question is primarily of interest in the context of the Parent-Subsidiary Directive. Closely linked to this, the article analysed whether the Parent-Subsidiary Directive permits reclassification of dividends into other types of income under domestic law. There seems to be a certain degree of consensus in the tax commentary that the residence state should not per se respect the classification in the source state. However, to some extent, the state of residence should respect the source state classification. This conclusion is based on the extent to which the interpretation of

the Parent-Subsidiary Directive is influenced by the objective of the Directive. As demonstrated, a teleological interpretation has generally been endorsed by the ECJ if this can be undertaken within the framework of a literal interpretation. Accordingly, companies are left without any clear guidelines but an indication of the interpretive style of the ECJ regarding the influence of the source state classification with respect to HFIs.

Fourth, the question was raised as to whether a Member State is allowed to deny the benefits of the Parent-Subsidiary Directive to combat cross-border tax arbitrage if the payment is deductible at the level of the company resident in the source state. It is concluded that the scope of the Parent-Subsidiary Directive cannot be narrowed on the basis of deductibility in the Member State of the paying company. Since the ECJ is not likely to apply a teleological interpretation to reduce the scope of the Directive, a literal interpretation should prevail. A reduction of the scope of the Directive should be based on specific provisions in the Directive allowing for this. The only option is to apply the fraud and abuse provision in Art. 1(2) of the Parent-Subsidiary Directive. However, it was concluded that tax arbitrage does not, as a general rule, constitute an abusive practice.

Fifth, the article examined whether or not HFIs that are not considered equity and instruments that are reclassified in a Member State can fulfil the holding requirements contained in the directives. In response to this issue, it was submitted that HFIs cannot constitute equity capital under the directives in terms of fulfilling the holding requirements of the directives.

Sixth, the applicability of the Arbitration Convention was analysed with respect to cases concerning classification inconsistencies. On this issue it was concluded that the Arbitration Convention does not apply to the classification of HFIs.

In summary, there is an obvious need to consider the application of the EU corporate tax directives with respect to HFIs in order to prevent tax legislation from constituting an obstacle to the use of HFIs. Hopefully, the Commission will take up this task as previously announced; if not, the ECJ will have the opportunity to provide the clarity needed in the short term.

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