

Hybrid Financial Instruments and Primary EU Law – Part 1

This article analyses the influence of EU law on hybrid financial instruments (HFIs). Part 1 addresses the impact of primary EU law on HFIs, identifies the applicable freedom, discusses the influence of the TFEU on the approach of Member States to classification and taxation of HFIs and addresses the conformity of coordination rules with EU law. Part 2, to be published in *European Taxation* 12 (2013), analyses potential justifications and the proportionality test.

1. Introduction

Taxes are a matter of national sovereignty within the European Union. In the absence of harmonization measures, Member States retain the competency to design their tax legislation and agree on bi- or multilateral tax treaties. It is, however, a mistake to conclude from this fact that direct taxes are not relevant in an EU law context. The enormous influence of the Treaty on the Functioning of the European Union (TFEU) (2007)¹ on the tax systems of the Member States is an undisputed fact.² Based on settled case law of the Court of Justice of the European Union (ECJ), the fundamental freedoms of the TFEU apply with regard to tax law.³ Thus, a vast number of cases have resulted in domestic tax law principles being set aside by the ECJ on the grounds that the domestic provision violates the fundamental freedoms and that the Member States are obliged to abstain from imposing any form of overt or hidden discriminatory or restrictive measures.

The objective of this research contribution is to analyse the influence of EU law on hybrid financial instruments (HFIs). The analysis covers primary EU law based on the TFEU.⁴ The analysis only deals with issues of particular

interest regarding cross-border HFIs and, therefore, does not outline all general EU tax law principles.

2. Issues Arising from Primary EU Law in the Context of HFIs

In order to analyse the implications of the fundamental freedoms on HFIs, it is necessary to take a closer look at the *consequences that may result from different forms of classification of HFIs* in Member States. The potential consequences of a particular classification are outlined in a variety of practical scenarios.

On the face of it, HFIs may be classified in a number of different ways. The most common method involves a debt versus equity classification. It is possible that instruments will be classified consistently in the Member States involved as debt or equity. This scenario would not give rise to any specific EU law issues in the context of HFIs.⁵ What is more interesting are situations involving inconsistent classifications. Such situations arise, for example:

- Where an HFI, according to the classification principles of the residence state, is considered debt while the same instrument is considered equity or treated as equity in the Member State of the receiving company (source state). Such treatment may be the result of specific legislation in the latter Member State or merely the result of different classification principles in the Member States involved;
- Where an instrument is treated as equity in the residence state of the investor and as debt in the country of the receiving company (source state). Such a scenario is typically the result of the application of different classification principles and can lead to situations of double non-taxation or deduction/non-inclusion and consequently minimal taxation. This situation is regulated by specific provisions in certain Member States, which are often referred to as coordination rules, synchronization rules or anti-arbitrage rules. There are two variations of such specific coordination provisions: (1) equity treatment is restricted in the Member State of origin of the investment and (2) debt classification is denied in the Member State of the receiving company.

The impediments caused by the above-described autonomous classification methods and results are clearly an obstacle to the functioning of the internal market. The in-

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1. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), EU Law IBFD.
 2. The ECJ has been called “[...] the most powerful tax force in Europe [...]” See P. Cussons & M. Frankland, *Why the ECJ is the Most Powerful Tax Force in Europe*, Intl. Tax Rev. 1, p. 39 et seq. (2003).
 3. See, for example, DE: ECJ, 1 July 1993, Case C-20/92, *Hubbard (Testamentvollstrecker) v. Hamburger*, para. 19.
 4. See W. Meilicke, *Finanzierungsfreiheit und Europarecht*, in *Unternehmensfinanzierung im Internationalen Steuerrecht*, p. 145 et seq. (D. Piltz & H. Schaumburg eds., Linde, 1995). The application of EU directives with respect to HFIs was analysed in J. Bundgaard, *Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1*, 50 Eur. Taxn. 10, pp. 442-456 (2010), Journals IBFD and *Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 2*, 50 Eur. Taxn. 11, pp. 490-500 (2010), Journals IBFD.

5. Obviously, other issues related to pure debt or equity financing may arise from an EU law perspective. This could include legislation on thin capitalization or dividend taxation. Such issues are not dealt with herein.

ternational double taxation that arises in situations of classification conflicts represents a mixture of both juridical and economic double taxation.⁶

On the basis of this description, two primary issues arise in the context of HFIs and EU law:

- (1) Whether or not EU Member States can maintain different classifications of HFIs or even reclassify HFIs. In light of this, an analysis follows with regard to whether or not an inconsistent classification of HFIs may lead to a result that is considered incompatible with EU law.

A subset of questions arises in this context:

- Whether or not a principle of per se instrument classification exists according to EU law?
 - Whether or not the TFEU requires that Member States abolish double taxation?
 - Whether or not domestic substance-over-form doctrines can be used to reclassify HFIs?
- (2) Whether or not the introduction of coordination rules by Member States, with the objective of ensuring single taxation of all income, may actually violate the EU fundamental freedoms.

There is no ECJ case law on either issue, which increases the uncertainty of the analysis.

3. Scope - Identifying the Applicable Freedom

According to established principles of ECJ case law, an analysis of national (tax) rules is carried out in steps. First, the scope is determined by identifying the applicable freedom. Second, the possible restriction or discrimination is identified. Third, whether or not the restriction or discrimination can be justified on the basis of objectives in the overriding public interest is analysed. Finally, if the domestic tax legislation in question can be justified, it must be examined whether or not the measure is proportionate.

In dealing with HFIs, the relevant TFEU provisions are articles 49 and 54 regarding the freedom of establishment and article 63 regarding the free movement of capital. HFIs are not, as such, mentioned in the TFEU. Such instruments may, however, be protected under article 49 of the TFEU regarding the freedom of establishment or article 63 regarding the free movement of capital.⁷

6. See, regarding classification conflicts with respect to selected HFIs, S.E. Bärsch, *Taxation of HFIs and the Remuneration Derived Therefrom in an International and Cross-border Context*, p. 241 et seq. (Springer 2012); S.E. Bärsch & C. Spengel, *Korrespondierende Besteuerung bei grenzüberschreitend eingesetzten hybriden Finanzinstrumenten*, *Die Unternehmensbesteuerung* 6, p. 377 et seq. (2013); and in the context of hybrid entities G. Fibbe, *EC Law Aspects of Hybrid Entities*, p. 132 et seq. (IBFD 2009).

7. Article 18 of the TFEU provides for a *lex generalis* prohibition against discrimination. According to established case law, the provision applies, however, only in situations in which the issue in question is not directly dealt with in the treaty. See GR: ECJ, 30 May 1989, Case 305/87, *Commission of the European Communities v. Hellenic Republic*, paras. 12 and 13, ECJ Case Law IBFD; NL: ECJ, 12 Apr. 1994, Case C-1/93, *Halliburton Services BV v. Staatssecretaris van Financiën*, para. 12, ECJ Case Law IBFD; GR: ECJ, Case C-311/97, *Royal Bank of Scotland plc v. Elliniko Dimosio*, para. 20, ECJ Case Law IBFD; BE: ECJ, 16 Sept. 1999, Case C-22/98, *Jean Claude Beccu*,

The scope of article 49 of the TFEU encompasses *establishment* in another Member State. According to ECJ case law, equity ownership in another company constitutes an establishment in the sense of article 49 if the situation involves subsidiaries controlled by a parent company. However, other freedoms may be relevant if the situation in question does not include controlled subsidiaries.⁸

The scope of article 63 of the TFEU is *capital movements* without consideration or payment. The notion of capital movements is referred to in article 1 of Council Directive 88/361/EEC for the implementation of article 67 of the Treaty⁹ (article 67 was repealed by the Treaty of Amsterdam) and further defined in Annex 1 to that Directive.¹⁰ According to ECJ case law, this nomenclature remains indicative for the purpose of defining the notion of capital movements.¹¹ The provision provides protection for both the state of origin and the source state. Article 63 is applicable to third countries as well.

The delineation between the freedom of establishment and the free movement of capital is important for at least two reasons: the differences in territorial and temporal scope.¹²

The outcome of the EU law analysis may be influenced by which TFEU provision applies. If domestic legislation applies to groups of companies, this may imply that the freedom of establishment in articles 49 and 54 of the TFEU should be applied. Thus, it is settled case law that the freedom of establishment applies when the national legislation in question concerns shareholders with a definite influence over another company.¹³ Based on this, it is of great importance whether or not the freedom of establish-

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Annie Verweire, Smeg NV, Adia Interim NV, para. 32; DK: ECJ, 28 Oct. 1999, Case C-55/98, *Bent Vestergaard*, para. 16, ECJ Case Law IBFD; NL: ECJ, 13 Apr. 2000, Case C-251/98, *C. Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, para. 23, ECJ Case Law IBFD; and UK: ECJ, 8 Mar. 2001, Joined Cases C-397/98 and C-410/98, *Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd v. Commissioners of Inland Revenue and HM Attorney General*, para. 38, ECJ Case Law IBFD.

8. See SE: ECJ, 21 Nov. 2002, Case C-436/00, *X and Y v. Riksskatteverket*, ECJ Case Law IBFD.

9. Treaty Establishing the European Community, 25 Mar. 1957, EU Law IBFD.

10. Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, OJ L178 (8 July 1988), Annex I (Nomenclature of the capital movements referred to in article 1 of the Directive).

11. See, for example, SE: ECJ, 19 Jan. 2006, Case C-265/04, *Margaretha Bouanich v. Skatteverket*, para. 29, ECJ Case Law IBFD, with further references to other case law.

12. See, for example, UK: Opinion of Advocate General Geelhoed, 29 June 2006, Case C-542/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, ECJ Case Law IBFD: *31. As the national court has raised the compatibility of the relevant UK legislation with the freedom of establishment, free movement of services and free movement of capital provisions of the Treaty (Articles 43, 49 and 56 EC), the first issue to consider is against which of these Treaty provisions the legislation should be assessed. This issue is important for two reasons. First, while Articles 43 and 49 EC apply only to restrictions on the exercise of freedom of establishment and freedom of services between Member States, Article 63 EC also prohibits restrictions on the movement of capital between Member States and third countries. Second, the temporal scope of Article 63 EC is different to that of Articles 43 and 49 EC: in particular, Article 63 EC entered into force and became directly effective on 1 January 1994, and is subject to a 'standstill' provision (Article 57 EC) as regards third States (although the principle of free movement of capital had already been established by Council Directive 88/361).

13. See, for example, *Thin Cap* (C-524/04), paras. 101 and 104.

ment alone applies. This question was definitively clarified in *Lasertec* (Case C-492/04).¹⁴ According to the ECJ, situations involving definite influence fall within the material scope solely of the TFEU provision relating to the freedom of establishment.

Despite the difference in wording of the relevant TFEU provisions, both fundamental freedoms apply to domestic legislation in the host state, as well as legislation in the state of origin.¹⁵

The purpose of the national legislation at issue should be reviewed when dealing with situations involving, possibly, more than one fundamental freedom, as that purpose can have a huge impact on whether or not a particular freedom is applicable. In *Commission v. Netherlands* (Case C-282/04)¹⁶ the free movement of capital was the predominant freedom because the national tax rule primarily affected capital movements. In *Lasertec* the national rule mainly affected the freedom of establishment based on the decisive influence on the borrower company. In *Fidium Finanz* (Case C-452/04),¹⁷ banking services via the internet were considered to fall under the freedom to provide services. In that case, the ECJ noted that the Court will examine the measure in dispute in relation to only one freedom if it appears that one of them is entirely secondary in relation to the other and may be considered together with it.

If a restriction on the free movement of capital is an inevitable consequence of a potential restriction on the freedom of establishment or any other freedom, according to settled ECJ case law, article 63 of the TFEU cannot be invoked.¹⁸ This applies even if the result is a narrowed geographic scope of treaty protection. Accordingly, the TFEU does not provide protection in a situation where a domestic parent company has established a subsidiary or a branch in a third country. Article 63 will, however, be applicable with respect to minority shareholders, for example, receiving dividends from a company resident in a third country outside the European Union/European Economic Area.

It should be recalled that, according to the ECJ, there is no per se comparability with regard to intra-community and third-country cross-border activities. This is due to the degree of legal integration between Member States and, in particular, the existence of the Mutual Assistance Directive

(2011/16/EU).¹⁹ In addition, it is possible that a Member State will be able to justify a restriction imposed on capital movements to and from third countries that would not be justifiable between Member States.²⁰

4. Influence of the TFEU on Member State Approaches to Classification and Taxation of HFIs

4.1. Introductory remarks

The overall and relevant question is whether or not the simultaneous application of different autonomous classification principles by Member States is acceptable from an EU law standpoint. This question is relevant, in particular, where double taxation arises as a consequence thereof. A number of relevant questions need to be addressed in this context.

4.2. Considerations on classification methods

Although autonomous classification methods only lead to classification conflicts in cross-border situations, these methods generally do not make a distinction, directly or indirectly, on grounds of nationality.²¹ Instead, such measures are a consequence of the simultaneous application of domestic rules regarding classification. This can be seen as a “quasi restriction”. Helminen (1999) states the following regarding EU law and the classification of HFIs:²²

[...] Nothing in EC Law, in principle, hinders the taxation of hybrid instruments in accordance with their economic substance rather than in accordance with their form. EC law does not affect the domestic tax law treatment of interest as a dividend or a dividend as interest as long as the domestic law treatment does not constitute forbidden discrimination with respect to the TFEU [...]

The author’s statement is obviously correct. The question, however, that remains is when the national classification of HFIs can, in fact, constitute a violation of the fundamental freedoms laid down in the TFEU. This question is analysed in section 4.3.

4.3. Double taxation and EU law

The situation of an HFI being treated as equity in the state of the receiving company and as debt in the Member State of the contributing company has not been dealt with directly by the ECJ in its case law.²³ Such an inconsistency

14. DE: ECJ, 10 May 2007, Case C-492/04, *Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen*.
 15. See UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty’s Inspector of Taxes)*, para. 31, ECJ Case Law IBFD: “31. Even though, according to their wording, the provisions concerning freedom of establishment are directed to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation (see, in particular, ICI, cited above, paragraph 21)”.
 16. NL: ECJ, 28 Sept. 2006, Case C-282/04, *Commission of the European Communities v. Kingdom of the Netherlands*, ECJ Case Law IBFD.
 17. DE: ECJ, 3 Oct. 2006, Case C-452/04, *Fidium Finanz AG v. Bundesanstalt für Finanzdienstleistungsaufsicht*, ECJ Case Law IBFD.
 18. See UK: ECJ, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, para. 33, ECJ Case Law IBFD; *Thin Cap* (C-524/04), para. 34 et seq., and *Fidium Finanz AG* (C-452/04), para. 48.

19. EU Mutual Assistance Directive (2011): Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ L 64 (2011), EU Law IBFD.
 20. See UK: ECJ, 12 Dec. 2006, Case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v. Commissioners of Inland Revenue*, para. 170 et seq., ECJ Case Law IBFD and SE: ECJ, 18 Dec. 2007, Case C-101/05, *A v. Skatteverket*, para. 37, ECJ Case Law IBFD.
 21. See Fibbe, *supra* n. 6, at p. 150.
 22. See M. Helminen, *The Dividend Concept in International Tax Law*, p. 266 (Kluwer 1999) and *The International Tax Law Concept of Dividend*, p. 170 (Kluwer 2010).
 23. There is significant case law in the area of domestic thin capitalization rules. See DE: ECJ, 12 Dec. 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, ECJ Case Law IBFD and *Thin Cap* (C-524/04). In BE: ECJ, 17 Jan. 2008, Case C-105/07, *NV Lammers & Van Cleeff v. Belgische Staat*, ECJ Case Law IBFD, Belgian reclassification rules resulting in reclassification of interest payments as loans from foreign directors

may lead to the denial of an interest deduction from the ongoing payments on the instruments in the source state while the payments at the recipient level in the state of origin of the investor may still be classified as interest and thus should be included in the taxable income of the investor depending on that Member State's tax legislation. This may lead to double taxation by way of non-deduction combined with inclusion at the level of the recipient, which is akin to economic double taxation. The argument that double taxation is a possible restriction, in the context of different classifications of financing yield, was made by the Commission in *Lankhorst-Hohorst* (Case C-324/00) (paragraph 35).²⁴

The Commission adds that Paragraph 8a(1), Head 2, of the KStG does indeed provide for an exception in the case of a company which proves that it could have obtained the loan capital from a third party on the same conditions, and fixes the permissible amount of loan capital in comparison with equity capital. However, the Commission points to the existence, in the present case, of a risk of double taxation since the German subsidiary is subject to German taxation on interest paid, whereas the non-resident parent company must still declare the interest received as income in the Netherlands. The principle of proportionality requires that the two Member States in question reach an agreement in order to avoid double taxation.

However, the Court did not decide upon this argument. German commentators doubt that Member States may uphold unilateral thin capitalization rules without considering taxation in the creditor state.²⁵

The question is whether or not double taxation should be abolished or avoided according to the fundamental freedoms. Accordingly, what follows is a summary of case law regarding this issue,²⁶ which reveals that the ECJ has not

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(being companies resident in another Member State) was overruled by the ECJ. In that case, the ECJ recognized the arm's length principle as a legitimate way of testing whether or not an abusive practice exists (see para. 30).

24. The same ideas are touched on in DE: Opinion of Advocate General Mischo, 22 Sept. 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, paras. 68-69, ECJ Case Law IBFD. However, from this proposal, it is clear that there is a risk of double taxation, but that this may be resolved according to article 9 of a tax treaty based on the OECD Model (*OECD Model Tax Convention on Income and on Capital* (22 July 2010), Models IBFD), as this provision may ensure the correct distribution of the right to tax and at the same time protect the tax revenues of the Member States involved.
25. See O. Thömmes, *Konzernfinanzierung und Europäisches Recht*, Der Betrieb, p. 2397 et seq. at p. 2402 (2002). The same conclusion was reached by O. Thömmes, B. Stricof & K. Nakhai, *Thin Capitalization Rules and Non-Discrimination Principles*, 32 Intertax 3, p. 126 et seq. at p. 135 et seq. (2004), wherein it is stated that the ECJ is expected to include potential double taxation as a restriction in future case law. W. Kessler, *Die Gesellschafter-Fremdfinanzierung im Spannungsfeld zum Recht der Doppelbesteuerungsabkommen und Europarecht*, Der Betrieb, p. 2507 et seq. at p. 2512 (2003) reaches the same conclusion, but focuses on the company level instead of the potential double taxation following consecutive taxation in the country of the parent company. The authors specifically analyse the German legislation, according to which a German parent company, under the German thin capitalization legislation, is 95% tax exempt with regard to interest received from a subsidiary. They note that German parent companies with foreign subsidiaries are taxed on the interest payments. This leads to a less favorable treatment of parent companies with foreign subsidiaries compared to domestic subsidiaries, which is why the German legislation seemingly constitutes a violation of EU Law.
26. According to the now repealed article 293 of the EC Treaty, double taxation should be mitigated within the European Union through negotiations between the Member States. The provision could not be directly applied by taxpayers within the European Union in order to avoid double taxation

developed consistent principles regarding the argument that there is a lack of harmonization. Van Thiel (2002) concludes that the ECJ has routinely rejected Member States' arguments on lack of harmonization as a justification for a restriction.²⁷ The ECJ has repeatedly held that the application of directly applicable TFEU provisions does not require harmonization of the legislation of the Member States.

In *Denkavit Internationaal BV* (Case C-170/05),²⁸ the ECJ concluded that France could not uphold domestic legislation imposing a withholding tax on intra-group dividends, which resulted in economic double taxation regarding dividends paid between France and the Netherlands parent company. The case related to transactions that occurred before the adoption of the EU Parent-Subsidiary Directive (2011/96).²⁹ It was concluded that the freedom of establishment precludes national legislation that imposes a withholding tax on dividends paid to a foreign parent company, whilst resident parent companies are almost fully exempt with regard to that tax. The ECJ stated in paragraph 29 that:

29. Such a difference in the tax treatment of dividends between parent companies, based on the location of their registered office, constitutes a restriction on freedom of establishment, which is, in principle, prohibited by Article 49 EC and Article 48 EC.

Regarding the question of comparability, the ECJ stated the following in paragraphs 34-35:

34. It is true that, in the context of measures laid down by a Member State in order to prevent or mitigate the imposition of a series of charges to tax on, or the double taxation of, profits distributed by a resident company, resident shareholders receiving dividends are not necessarily in a situation which is comparable to that of shareholders receiving dividends who are resident in another Member State.

35. However, as soon as a Member State, either unilaterally or by way of a convention, imposes a charge to tax on the income, not only of resident shareholders, but also of non-resident shareholders, from dividends which they receive from a resident company, the situation of those non-resident shareholders becomes comparable to that of resident shareholders.

Access to relief from juridical double taxation was at stake in *Kerckhaert-Morres* (Case C-513/04).³⁰ The ECJ did not agree with the position of the taxpayers that Belgium

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in respect of cross-border transactions. See FR: ECJ, 12 May 1998, Case C-336/96, *Gilly v. Directeur des services fiscaux du Bas-Rhin*, paras. 15-16, ECJ Case Law IBFD.

27. See S. van Thiel, *Free movement of Persons and Income Tax Law: The European Court in Search of Principles*, p. 392 et seq. (IBFD 2002). ECJ case law was, for example, analysed in L. Denys, *The ECJ case law on cross-border dividends revisited*, 47 Eur. Taxn. 5, p. 221 et seq. (2007), Journals IBFD; F. Vanistendael, *Denkavit Internationaal: The balance between fiscal sovereignty and the fundamental freedoms?*, 47 Eur. Taxn. 5, p. 210 et seq. (2007), Journals IBFD; and T. O'shea, *Dividend Taxation Post-Manninen: Shifting Sands or Solid Foundations?*, Tax Notes Int'l, p. 887 et seq. (5 Mar. 2007).
28. FR: ECJ, 14 Dec. 2006, Case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, ECJ Case Law IBFD.
29. EU Parent-Subsidiary Directive (recast) (2011): Council Directive 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, (2011), EU Law IBFD.
30. BE: ECJ, 14 Nov. 2006, Case C-513/04, *Mark Kerckhaert and Bernadette Morres v. Belgische Staat*, ECJ Case Law IBFD.

should ensure that no juridical double taxation is imposed regarding dividend payments from a French company to the individual shareholders in Belgium. France levied a 15% withholding tax on the dividends. Belgium did not allow a tax credit for the French withholding tax and taxed the dividend at a rate of 25%. The same rate was applicable to shareholders of domestic companies.

Such tax legislation did not constitute a restriction within the meaning of article 63 of the TFEU, as:

20. In circumstances such as those of the present case, the adverse consequences which might arise from the application of an income tax system such as the Belgian system at issue in the main proceedings result from the exercise in parallel by two Member States of their fiscal sovereignty.

Further, it was stated in paragraph 22 that:

22. Community law, in its current state and in a situation such as that in the main proceedings, 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.

Accordingly, juridical double taxation existing because of the simultaneous exercise of the fiscal sovereignty of two Member States cannot be prevented by forcing one Member State to allow for a credit or exemption. This case is fully consistent with the *Denkavit* case since *Denkavit* concerned a situation in which a Member State unilaterally chose to provide relief for economic double taxation (which was also the result of the taxes imposed by that state) and thus was required to expand this relief to all corporate shareholders irrespective of their residence. This was further developed in *Meilicke* (Case C-292/04)³¹ and *Manninen* (Case C-319/02)³² wherein it was held that German and Finnish double taxation mitigation systems constituted a violation of the free movement of capital because they did not allow a credit for individual taxpayers who received dividends from foreign companies. The *Kerckhaert-Morres* decision, however, merely involved a situation in which double taxation occurred as a result of the simultaneous exercise of the fiscal sovereignty of two Member States.

Denys (2007)³³ summarizes the ECJ case law rules according to the following categories:

- Home state equal treatment of EU and domestic dividends received by resident companies;
- Home state equal tax treatment of EU and domestic dividends received by resident individual shareholders;
- Source state equal tax treatment of domestic dividends received by resident and non-resident EU companies; and

31. DE: ECJ, 6 Mar. 2007, Case C-292/04, *Wienand Meilicke, Heidi Christa Weyde and Marina Stöffler v. Finanzamt Bonn-Innenstadt*, ECJ Case Law IBFD.

32. FI: ECJ, 7 Sept. 2004, Case C-319/02, *Petri Manninen*, ECJ Case Law IBFD.

33. Denys, *supra* n. 27.

- Source state equal tax treatment of domestic dividends received by resident and non-resident EU individual shareholders.

Economic double taxation and juridical double taxation may be contrary to the basic rules of an internal market but the ECJ will not intervene in cross-border situations in which double tax burdens result from the simultaneous operation of two distinct tax systems.

According to Kollruss (2007),³⁴ a situation in which interest is treated as a dividend in the host state – and is non-deductible – and as interest in the state of origin (*positiver Qualifikationskonflikt*) does not fall under the scope of the fundamental freedoms because the potential double taxation is merely a result of disparate tax systems (*disparitätischen Steuersystemen*). Moreover, the author states that no obligation exists under EU law to reclassify the interest as a dividend payment in the state of origin (here Germany).

Based on the principles presented in this section it can be concluded that the TFEU does not prohibit double taxation when it is the result of the exercise by Member States of their sovereignty and the Member States do not treat domestic and cross-border transactions differently. The ECJ has stated that, in principle, double taxation is not in itself unlawful, as there is no obligation for Member States to adapt their own tax systems to the tax systems of other Member States in order to eliminate the double taxation arising from the exercise in parallel of their fiscal sovereignty.³⁵ Member States are not per se required to relieve economic double taxation (except in the cases covered by the Parent-Subsidiary Directive (2011/96)). Nevertheless, the ECJ has held that economic double taxation might be contrary to EU law if it reflects a difference in treatment between domestic and cross-border situations, leading to discrimination. Juridical double taxation represents an obstacle to cross-border activity and investment within the European Union.³⁶ In this respect, the ECJ has emphasized the importance of tax treaties.³⁷ Restrictions on cross-border investments can, in fact, be viewed as “quasi restrictions”, which do not constitute a violation of the TFEU, since such restrictions are a direct and inevitable consequence of the parallel exercise of the taxing rights of the Member States.³⁸ Double taxation in the context of HFI

34. T. Kollruss, *Weisse und graue Einkünfte bei Outbound-Finanzierung einer ausländischen EU-Tochterkapitalgesellschaft nach Europarecht und dem JStG 2007*, 62 *Betriebs Berater* 9, p. 475 (2007).

35. See *Kerckhaert-Morres* (C-513/04), para. 20 and DE: ECJ, 6 Dec. 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt*, para. 43, ECJ Case Law IBFD and BE: ECJ, Case C-540/11, 19 Sept. 2012, *Daniel Levy and Carine Sebbag v. État Belge*, ECJ Case Law IBFD. See also M. Lang, *ECJ case law on cross-border dividend taxation – recent developments*, 17 *EC Tax Rev.* 2, p. 68 (2008); J. Monsenego, *Double Taxation in the EU: The Future After Block*, *Tax Notes Int'l*, p. 215 et seq. (20 April 2009) and K. Daxkobler & E. Huisman, *Levy & Sebbag: The ECJ Has Once Again Been Asked To Deliver Its Opinion on Juridical Double Taxation in the Internal Market*, 53 *Eur. Taxn.* 8, p. 400 et seq. (2013), *Journals IBFD*.

36. See European Commission, *Public Consultation paper: taxation problems that arise when dividends are distributed across borders to portfolio and individual investors and possible solutions*, 28 Jan. 2011, p. 4.

37. See, for example, *Gilly* (C-336/96), para. 31.

38. The term “quasi restriction” was introduced by Advocate General Geelhoed in UK: *Opinion of Advocate General Geelhoed*, 23 Feb. 2006,

can, therefore, be seen as a result of the lack of tax law harmonization.

4.4. Per se classification of financial instruments

It has been argued that legal entities and financial instruments recognized for private law purposes in one Member State must also be recognized as such in the other Member States.³⁹

Such an argument is primarily based on ECJ case law regarding the impact of the freedom of establishment on company law principles regarding residence and legal personality. It follows from settled ECJ case law that, pursuant to the freedom of establishment, a company that has been validly established in one Member State should be recognized in all other Member States as such.⁴⁰ It is argued that ECJ case law regarding non-tax issues should be relevant in the field of tax law.⁴¹ Further, it is reasoned that non-recognition of a share or a convertible bond issued by a company in another Member State is very similar to non-recognition of the issuing company itself. This further development of the reasoning of the ECJ is said to find support in *Inspire Art* (Case C-167/01).⁴² In *Inspire Art* a UK company should have been recognized as such under Netherlands law. Thus, it constituted a violation of the freedom of establishment to impose restrictions on the branch of UK Ltd. in the Netherlands regarding capital requirements and the liability of management. The case does not appear to contain an obiter dictum, indicating that the stated principles automatically apply to other areas of the law.

Ultimately, it has been argued that reclassification of convertible bonds issued by a company of one Member State (for example, into an option for tax law purposes) would make it less attractive to offer convertible bonds to investors resident in the Member State that makes the reclassification and that it would become less attractive to acquire the convertible bond.⁴³ Finally, it is argued that such a restriction can hardly be justified on the basis of the present justification grounds accepted by the ECJ.

It seems questionable whether or not reclassification or simply a different classification is similar to non-recognition of a company established and legally recognized

in another Member State. Moreover, the cases presented concern company law issues. One would expect that the ECJ would refer to the doctrines developed within the field of direct tax law. There is little support for the idea that every (hybrid) financial instrument issued by an EU company should be classified in the exact same way in all Member States.

The issue of classification inconsistencies was extensively analysed by Fibbe & de Graaf (2005).⁴⁴ Despite the thorough analysis, the authors do not reach a firm conclusion on the question but find it likely that the ECJ will set aside domestic legislation resulting in double taxation. The authors were, however, only considering situations involving double taxation. Their conclusion is that autonomous classifications not leading to double taxation may not constitute a violation of EU law. A more extensive analysis was conducted by Fibbe (2009).⁴⁵ He concludes that:

[...] If two or more Member States classify an entity differently whereby one Member State ignores the personality granted under a foreign (Member) State's tax law, the state of origin might tax the profits of the same enterprise as the host state. In that situation the international double taxation is caused by the principle of residence applied both by the residence state of the participants and the residence state of the entity. The assumption that the principle of worldwide taxation of resident companies and the principle of source (limited tax liability) are not in conflict with EC law leads to the question whether the application of these principles is unaltered in a situation where there is a classification conflict between Member States and the personality granted for tax purposes by a Member State is ignored by another Member State. In the absence of Community law, Member States are in principle free to adopt their own classification methods. Nonetheless, this sovereignty should be applied in line with the rights embodied in the TFEU [...].

And further:

[...] Classification conflicts due to autonomous classification methods only arise in situations where an entity incorporated under the laws of one state is involved (actively or passively) in cross-border activities and as a consequence is classified for the tax purposes of two or more Member States. The question arises whether EC law determines in such situations whether the tax classification in the host state or in the state of origin prevails [...].

And finally:

[...] According to the author, corporate resemblance-based methods are in accordance with objective criteria derived from the respective corporate income tax systems of the Member State involved. Economic and juridical international double taxation due to classification conflicts are the result of differences in Member States' tax laws. This disparity falls outside the scope of the TFEU freedoms and can only be eliminated by policy at the EC level. Nonetheless, the autonomy of Member States to use their own classification methods should be adopted without distinction, either directly or indirectly, on the grounds of nationality [...].

The author finds this analysis to be correct and in line with ECJ case law and the current state of EU law. Moreover, the author considers the analysis to be equally valid with

Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, para. 38, ECJ Case Law IBFD. See J. Wittendorff, *Grænseoverskridende porteføljeudbytter I en EU-skatteretlig belysning*, SR-Skat, p. 82 et seq. fn. 157 (2011) for further references to case law.

39. See, for example, a few Danish commentators: G. Nielsen & R.K. Feldhusen, *Forankring eller løsrivelse – om forholdet mellem civilretten og skatteretten*, in *Festskrift til Ole Bjørn*, p. 204 et seq. (Djøf / Jurist- og Økonomforbundet 2004); S.F. Hansen, *At være eller ikke at være selskabsdeltager – det er spørgsmålet – Om kvalifikation af komplementarer og interessenter i dansk civilret og skatteret*, SpO p. 122 et seq. (2004) and N. Vinther, *Civilrettens styring af skatteretten*, p. 307 et seq. (Jurist- og Økonomforbundets Forlag 2004).
40. See DE: ECJ, 5 Nov, 2002, Case C-208/00, *Überseering BV v. Nordic Construction Company Baumanagement GmbH (NCC)*, ECJ Case Law IBFD.
41. See, for example, Hansen, *supra* n. 39, at p. 122 et seq. and E. Werlauff & N. Vinther, *Sagen om Inspire Art*, SU 2003.386.
42. NL: ECJ, 30 Sept. 2003, Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd*, ECJ Case Law IBFD.
43. See Nielsen & Feldthussen, *supra* n. 39, at p. 250.

44. G. Fibbe & A. de Graaf, *Is double taxation arising from autonomous tax classification of foreign entities incompatible with EC law?*, in *A Tax Globalist: Essays in Honour of Maarten J. Ellis*, p. 237 et seq. (H. van Arendonk et al. eds., IBFD 2005).
45. Fibbe, *supra* n. 6, at p. 129 et seq. and p. 176 et seq. (footnotes omitted).

regard to the area of financial instrument classification, where the same type of impediments can occur.

4.5. Reclassification on the basis of substance-over-form approaches

It is possible that classification asymmetries will arise as a consequence of the application of specific substance-over-form doctrines in certain Member States. The implications of this may be similar to what was described previously in section 4. However, separate legal questions should be addressed in the context of domestic substance-over-form doctrines. Initially, there should be no conflict if the domestic substance-over-form doctrine applies generally to intra Member State, as well as to cross-border inter Member State, transactions.

It should be noted here that ECJ case law seems to require that the criteria for the application of such doctrines be clear and foreseeable in order to be in accordance with the principle of legal certainty.

At the outset, it seems fair to assume that such domestic substance-over-form doctrines can constitute a restriction of the free movement of capital or the freedom of establishment since the consequence of the application of such clauses typically is a reclassification of purported debt as equity or purported equity as debt.⁴⁶ Thus, the application of substance-over-form doctrines may be very similar to that of national thin capitalization regimes, which the ECJ has already addressed.

Given this conclusion, the next step is to analyse possible justifications for the restrictions imposed. In this respect, the justification regarding prevention of tax avoidance is of key importance. The ECJ recognizes the Member States' need to combat tax avoidance. Thus, national legislation that is intended to prevent tax avoidance and is proportionate should not be set aside from an EU law perspective. Due to the nature and objective of substance-over-form clauses, such doctrines are more likely not to constitute a violation of the TFEU freedom in question. Some substance-over-form clauses have been developed in the case law and are specifically aimed at abusive practices. The ECJ recognizes certain national practices. The line between acceptable tax avoidance and unacceptable tax abuse was clarified by the ECJ in its decision in *Cadbury Schweppes* (Case C-196/04). It is not, however, possible to conduct a general analysis of all European substance-over-form clauses in light of the above framework.

Moreover, it should be recalled that a substance-over-form principal has been applied by the ECJ itself in cases regarding abuse of EU law. An important case in this respect is *Halifax* (Case C-255/02).⁴⁷ In that case the ECJ concluded

46. See, for an early analysis regarding the general German tax avoidance rule in DE: General Tax Code, section 42, National Legislation IBFD, A.J. Rädler et al., *Tax Abuse and EC Law*, 6 EC Tax Rev. 2, p. 86 et seq. (1997). In cases of tax abuse, the provision enforces taxation in accordance with a legal arrangement that would be appropriate to the economic transaction.

47. UK: ECJ, 21 Feb. 2006, Case C-255/02, *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v. Commissioners of Customs & Excise, BUPA Hospitals Ltd, Goldborough Developments Ltd v. Commissioners of Customs and Excise and University*

that a VAT deduction could not be allowed under the Sixth VAT Directive (77/388)⁴⁸ when the transactions on which that right was based constituted an abusive practice.⁴⁹ For a practise to be found to be abusive it is necessary, first, that the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth VAT Directive and of national legislation, 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.⁵⁰ The result in the *Halifax* case is in line with settled case law in other areas of EU law according to which EU law cannot be relied on for abusive or fraudulent ends.⁵¹ Moreover, the application of EU law cannot be extended to cover abusive practices by economic operators.⁵² The ECJ, in this respect, describes abusive practices as transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by EU Law.⁵³ The ECJ, however, did find it entirely irrelevant for the interpretation of the Sixth VAT Directive whether or not the sole purpose of a given transaction was to obtain a tax advantage.⁵⁴

As seen in *Halifax*, the ECJ has not hesitated to accept an approach similar to a substance-over-form approach within the sphere of VAT. Accordingly, it can be anticipated that the ECJ will not automatically set aside national substance-over-form doctrines. Nevertheless, it has been argued that it is obvious that the ECJ does not accept substance-over-form approaches under national tax law. The argument is based solely on the decision in *Traghetti del Mediterraneo SpA* (Case C-173/03).⁵⁵ One of the questions before the ECJ was whether or not EU law precludes national legislation such as that at issue in the main proceedings that, firstly, excludes all state liability for damages caused to individuals by an infringement of EU law committed by a national court adjudicating in the final instance where that infringement is the result of an interpretation of

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of *Huddersfield Higher Education Corporation v. Commissioners of Customs and Excise*, ECJ Case Law IBFD.

48. EU Sixth VAT Directive: Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, EU Law IBFD.

49. *Halifax* (C-255/02), para. 85.

50. *Halifax* (C-255/02), para. 86.

51. See *Halifax* (C-255/02), para. 86 with reference to GR: 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 Case Law IBFD; GR: ECJ, Case C-373/97, 23 Mar. 2000, *Dionysios Diamantis v. Elliniko Dimosio (Greek State) and Organismos Ikonomikis Anasygkrotisis Epicheiriseon AE (OAE)*, para. 33, ECJ Case Law IBFD; and DE: ECJ, 3 Mar. 2005, Case C-32/03, *I/S Fini H v. Skatteministeriet H*, para. 32, ECJ Case Law IBFD.

52. *Halifax* (C-255/02), para. 69.

53. See *Halifax* (C-255/02), para. 69 with reference to DE: ECJ, Case 125/76, 11 Oct. 1977, *Peter Cremer v. Bundesanstalt für landwirtschaftliche Markordnung*, para. 21 and DE: ECJ, Case C-8/92, 3 Mar. 1993, *General Milk Products GmbH v. Hauptzollamt Hamburg-Jonas*, para. 21, ECJ Case Law IBFD.

54. See *Halifax* (C-255/02), para. 59.

55. IT: ECJ, 13 June 2006, Case C-173/03, *Traghetti del Mediterraneo SpA v. Repubblica italiana*. See S.F. Hansen, *Nekrolog over "realitetsgrundsaetningen"* SpO, p. 1 et seq. (2007).

provisions of law or of an assessment of the facts and evidence carried out by that court.⁵⁶ The ECJ answered this question by stating that EU law precludes such national legislation by reason of the fact that the infringement in question results from an interpretation of provisions of law or an assessment of facts or evidence carried out by that court.⁵⁷ Based on this decision, it has been argued that a similar protection applies under all provisions in the TFEU granting EU citizens rights.⁵⁸ In fact, it is argued that such a rule also applies to the interpretation of regulations and directives.⁵⁹

Admittedly, this author finds this reasoning troubling taking into consideration ECJ case law regarding tax abuse and given that substance-over-form doctrines are traditionally developed as a response to tax abuse.

4.6. Interim conclusion

In conclusion, the simultaneous application of different autonomous domestic classification principles is generally acceptable from an EU law perspective. The difference is a natural consequence of the simultaneous exercise of the taxing right of Member States in the absence of harmonization measures. Accordingly, there are no legal remedies based on primary EU law available to EU corporations who might face the consequences of different classifications of HFIs in different Member States provided such consequences not only target cross-border transactions and accordingly are not based on nationality.

5. EU Law Conformity of Coordination Rules

5.1. In general

Assuming that there is currently no EU law principle that requires classification consistency, inconsistent classifications of HFIs may also arise that are potentially to the advantage of taxpayers. Inconsistent classifications of HFIs can prove advantageous from a taxpayer perspective if an instrument is considered equity in the Member State of residence of the investors and debt in the Member State of residence of the issuer. Such scenarios may lead to double non-taxation or deduction/non-inclusion depending on the actual content and impact of the national legislation and the HFIs in question.

Cross-border tax arbitrage is a high-ranking topic in the current international fiscal debate. Countries and international organizations struggle to determine what to do about it and on this basis to identify the appropriate technical measures. One approach to curbing cross-border tax arbitrage is the application of “coordination rules”, “synchronization rules”, “harmonization rules” or “linking rules”

56. See *Traghetti del Mediterraneo SpA* (C-173/03), para. 24.

57. See *Traghetti del Mediterraneo SpA* (C-173/03), para. 46.

58. See Hansen, *supra* n. 55, at p. 6. As an example it is stated, with reference to the free movement of services and capital, that it is of great importance to the protection of a service provider that the transaction be classified as a “service” and for a capital provider that the transaction be classified as a “capital movement”.

59. *Id.*

relying on the “principle of correspondence”.⁶⁰ According to this principle, tax benefits (deductions or exemptions) are made dependant on the tax treatment in another jurisdiction, for example, corresponding taxation of the same payment (dividend, interest, etc.) in such other jurisdiction will be required.

In a European context, two legislative approaches exist to neutralize the effect of cross-border tax arbitrage:⁶¹

- (1) limiting the scope of the participation exemption regime if the payments on HFIs are deductible at the level of the issuing company;⁶² 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.⁶³

These provisions, in effect, represent specific anti-arbitrage provisions introducing unilateral synchronization efforts.⁶⁴ In the analysis that follows, domestic legislative measures that may generally have an impact on tax arbitrage through hybrid mismatch arrangements, but are not specifically targeted provisions, are not addressed.

The following briefly introduces unilateral anti-arbitrage measures and then moves on to take a closer look at the EU law conformity of such provisions. The article provides an overview without addressing specific provisions. Accordingly, the relevant criteria that may be used in reaching future conclusions are presented. Such an analysis is even more relevant in light of recent OECD and EU recommendations for Member States to consider introducing or revising specific and targeted rules denying benefits with regard to certain hybrid mismatch arrangements.⁶⁵ The recommendations are based on the conclusion that such rules hold significant potential to address certain hybrid mismatch arrangements.

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60. See, on coordination rules, V. Thuronyi, *Coordination Rules as a Solution to Tax Arbitrage*, Tax Notes Intl, p. 1053 et seq. (22 Mar. 2010) and J. Bundgaard, *Coordination Rules as a Weapon in the War against Cross-Border Tax Arbitrage – The Case of Hybrid Entities and Hybrid Financial Instruments*, 67 Bull. Intl. Taxn. 4/5, p. 200 et seq. (2013), Journals IBFD.
 61. See OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, p. 15 et seq. (2012), International Organizations’ Documentation IBFD.
 62. *Id.*, at p. 18 et seq. This approach was even agreed upon by the EU Code of Conduct Group. The Group agreed that “[...] in as far as payments under a hybrid loan arrangements are qualified as a tax deductible expense for the debtor in the arrangement, Member States shall not exempt such payments as profit distributions under a participation exemption”. No formal agreement was made and further work is needed. See the Report of the Code of Conduct Group (Business Taxation) to the ECOFIN Council of 8 June 2010 No. 1033/10.
 63. See OECD, *supra* n. 61, at p. 17 et seq.
 64. See K. Dziurdz, “Circularly Linked” Rules Countering Deduction and Non-Inclusion Schemes: Some Thoughts on a Tie-Breaker Test, 67 Bull. Intl. Taxn. 6, p. 308 (2013), Journals IBFD, regarding possible problems arising if such rules are “circularly linked”, i.e. where no final decision can actually be taken with respect to the treatment of the payment in question if both countries apply coordination rules to the same payments. The author, moreover, presents some possible solutions to this problem.
 65. See OECD, *supra* n. 61, at p. 25 and Declaration on Base Erosion and Profit Shifting, adopted 29 May 2013 and Commission Recommendation on aggressive tax planning, C(2012) 8806 final (6 Dec. 2012).

5.2. Domestic responses to cross-border tax arbitrage through the use of HFIs

5.2.1. The United Kingdom (2005 and 2009)

The United Kingdom introduced tax law provisions in Finance Act 2005 to combat tax arbitrage, including arbitrage arising through the use of hybrid finance.⁶⁶ 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 is aimed at 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”, which is contained in the rules.^{67,68} Guidance on the legislation has also been issued by the UK tax authorities.⁶⁹ The UK legislation impacts both deductibility and the tax treatment of payments received from HFIs. The legislation is highly complex and gives rise to a number of uncertainties.

The UK rules concern deductibility of financing costs, as well as receipts from HFIs. The rules are applicable only if HMRC issues a “notice”.

An interest deduction may be denied if the recipient is not subject to effective taxation of the interest. This restriction requires the fulfilment of the following criteria:

- the transaction giving rise to the deduction must be part of a scheme involving the use of a hybrid entity or hybrid instrument;
- the scheme must have certain specific characteristics (a “qualifying scheme”) that allow the hybrid entity or hybrid instrument to create either a double deduction or a deduction not matched by a taxable receipt; and
- the main purpose or one of the main purposes of the scheme must be to obtain a UK tax advantage.

It is essential to determine whether or not the financing arrangement would have taken place in the absence of a tax benefit. This is explained in paragraph 22 of the Guidance Notes:

The existence of a UK tax deduction is not enough in itself to show that a scheme has a main purpose of obtaining a UK tax advantage. A tax advantage’s main purpose implies that in the absence of the scheme, tax deductions arising from the scheme would not have risen at all, or would have been of a lesser amount. Hence, it will be relevant to draw a comparison in order to consider whether, in the absence of the hybrid entity or instrument:

- the transaction giving rise to the deduction would have taken place at all;
- if so, whether it would have been of the same amount; and
- made under the same terms and conditions.

66. See UK: Finance (No. 2.) Act 2005, sections 24 to 31 and Schedule 3 to UK: F (No. 2) A 2005. The background for introducing the legislation was criticized by M. Boyle, *Cross-border tax arbitrage – policy choices and political motivations*, British Tax Rev. 5, p. 527 et seq. (2005). See OECD, *supra* n. 61, at p. 18, para. 50.

67. See D. Hill & E. Nendick, *UK: Government continues to clamp down tax avoidance*, Intl. Tax Rev. (2006), Supplement – Capital Markets.

68. *Id.*

69. See HMRC Guidance, FA 96/S91A-G, entitled “Taxing loan relationships: anti-avoidance: shares as debt” and HMRC Avoidance involving tax arbitrage, Guidance Notes.

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

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

The effect of fulfilling these requirements is that the receipts are considered taxable income.⁷⁰ Based on the UK anti-arbitrage provision, it has been recommended to corporate taxpayers to ensure that there are other reasons for the use of HFIs than mere fiscal ones.⁷¹ The participation exemption was not introduced until 2009.⁷² According to the recently adopted legislation, dividend receipts are generally taxable if they are not exempt.⁷³ An exemption is granted regarding distributions received by “small companies” (section 931B of the CTA) and other companies that are not “small” (section 931D of the CTA).⁷⁴ The provisions are designed to ensure that the vast majority of dividends will be exempt.⁷⁵ Certain requirements have to be met to obtain 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.”⁷⁶

5.2.2. Germany (2007 and 2013)

As part of the 2007 Annual Tax Act,⁷⁷ certain changes were made to combat tax arbitrage in the context of the tax treatment of interest on outbound shareholder loans.⁷⁸ The amendments narrowed the scope of the domestic participation exemption provision in section 8(b) of the Corporate Income Tax Act (CITA)⁷⁹ both regarding reclassified interest in the form of constructive dividends and with respect to exempt income due to a tax treaty. Clearly, the changes are relevant in the context of cross-border arbi-

70. See Guidance Notes, *supra* n. 69, at para. 53.

71. See Hill & Nendick, *supra* n. 67.

72. See UK: Finance Act 2009, Schedule 14, National Legislation IBFD inserting new part 9 A of UK: Corporate Taxation Act (CTA), National Legislation IBFD. Prior to this the United Kingdom had a modified imputation system.

73. See sec. 931A CTA.

74. See, for interpretation, Distribution exemption – draft guidance, HMRC 2009 and P. Cussons, *UK Government proposals for the taxation of foreign profits*, 54 British Tax Rev. 1, p. 1 et seq. (2009) and P. Voisey, *Finance Act Notes: Section 34 and Schedule 14 – Corporation Tax Treatment of Company Distributions Received*, 54 British Tax Rev. 5, p. 533 (2009).

75. See Distribution exemption – draft guidance, *supra* n. 74, at p. 1.

76. See secs. 931B(c) and 931(D)(c) CTA.

77. DE: Annual Tax Act (*Jahressteuergesetz* – JStG), 2007.

78. See H. Plewka & K.E.M. Beck, *German Tax Issues for Hybrid Forms of Financing*, 44 Tax Notes Int'l 5, p. 375 et seq. (2006) and *German Tax Treatment of Interest for Outbound Shareholder Loans*, 44 Tax Notes Int'l 6, p. 453 et seq. (2006); O. Dörfler, R. Heurung & G. Adrian, *Korrespondenzprinzip bei vGA*, DStR, p. 514 et seq. (2007) and Kollruss, *supra* n. 34, at p. 467 et seq.

79. DE: Corporate Income Tax Act (*Körperschaftsteuergesetz* – KStG), National Legislation IBFD.

trage. Under the German thin capitalization provision in section 8(a) of the CITA interest payments on loans also granted to domestic shareholders were treated as dividends. This offered excellent benefits for domestic corporate creditor shareholders due to the classification of the payment as interest in the foreign jurisdiction and as a dividend in Germany. The limitation on the scope of the participation exemption regime that was enacted with respect to constructive dividends (*verdeckte Gewinnausschüttungen*) requires that the interest payment be deductible in the state of the debtor. The changes are not specifically aimed at HFIs but they represent domestic counter-measures against cross-border tax arbitrage that may affect HFIs.

More recently, as a part of the 2013 Annual Tax Act, another coordination effort was introduced with respect to the German participation exemption regime (section 20 Abs. 1 of the Income Tax Act).⁸⁰ According to this change, the above limitation with respect to concealed dividends now applies to all dividends. This means that the participation exemption is not granted to the extent that the dividend is deductible in the state of the payor. The amendment specifically targets white income (*Weisse Einkünfte*) arising under qualification conflicts with regard to HFIs.

5.2.3. Denmark (2007 and 2009)

In 2007, a specific provision aimed at tax arbitrage structures using inbound HFIs was introduced into Danish tax law as section 2 B of the Corporate Tax Act (CTA).⁸¹ For some years now it has been Denmark's fiscal policy for the domestic tax treatment of certain transactions to depend on the tax treatment in other jurisdictions.⁸² The underlying tax policy rationale has been widely criticized due to the fact that this requires Denmark to take on a coordinating role between different countries regarding the classification of HFIs, while a similar effort is not required where double taxation occurs in cross-border transactions as a result of different classifications of the same financial instrument.

The objective of section 2 B of the CTA is to abolish the potential asymmetrical tax treatment of certain hybrid financial instruments. Such asymmetrical taxation may arise by way of a different tax classification of an instrument in the countries involved, for example, the Danish classification, for tax purposes, of the payment as debt, resulting in an interest deduction for Danish tax purposes, while the instrument in the country of the investor is considered equity, which, depending on the legislation of that state, may result in tax exempt dividends.

In essence, the provision provides that if a Danish taxable company is indebted to an individual or a company that is resident in another country and the claim, according to foreign tax rules, is considered as paid-in capital, the debt will also be regarded as equity for Danish tax purposes. From a practical point of view it is important to note that the Danish anti-arbitrage provision only addresses inbound hybrid instruments that may give rise to interest deductions in Denmark. The provision is aimed directly at HFIs. However, no examples are provided in the legislation or the preparatory work regarding which instruments fall under the substantive scope of the provision and between which countries the required asymmetry may arise. The applied or underlying definition of HFIs is as follows: "instruments classified as equity in one country while classified as debt in another country". This rather broad definition was criticized in the hearing process, as it may lead to uncertainty.⁸³

The application of the provision requires that a number of requirements be fulfilled simultaneously, which can be derived directly from the wording of the provision. This includes a condition that the financial instrument be considered debt for Danish tax purposes.

The rule only applies if the foreign individual or the foreign company has decisive influence over the Danish company or if the companies are considered to fall within a group of companies. The consequence is that the interest payments and capital losses of the company are considered to be dividend payments.

The final requirement that must be met under section 2 B is that the Danish debt instrument be treated as equity/paid-in capital according to the tax legislation of the "creditor's" state of residence. Thus, the tax treatment of a Danish company is now dependant on the tax treatment in foreign jurisdictions. This issue was addressed in the hearing process, wherein it was stated that it seems unreasonable to require knowledge of foreign tax legislation. In response, the Danish Minister of taxation simply stated that such a task does not seem insurmountable given that the provision is aimed at related group companies (and controlling individual shareholders) and that one could simply abstain from using HFIs.

The test for whether or not an HFI actually exists should be carried out at the time of the creation of the instrument or at the time the provision takes effect. The Minister of Taxation has stated that if the creditor moves to another jurisdiction during a tax year a new test should be applied in order to determine whether or not section 2 B is applicable in the changed setting.

Section 2 B states that treatment as "paid-in capital" in the state of the investor should result in the payment

80. DE: Income Tax Act (*Einkommensteuergesetz – EStG*), sec. 20 Abs. 1, National Legislation IBFD.
 81. DK: Corporate Tax Act, National Legislation IBFD, as amended by Law No. 344 enacted on 18 Apr. 2007 based on Bill No. L 110 B. The provision and its background was analysed in J. Bundgaard, *Cross-Border Tax Arbitrage Using Inbound Hybrid Financial Instruments Curbed in Denmark by Unilateral Reclassification of Debt to Equity*, 62 Bull. Intl. Taxn. 1, p. 33 et seq. (2008), Journals IBFD.
 82. See, in general, A. Michelsen in *Festskrift til Mattson*, p. 277 et seq. (K. Ståhl & P. Thorell eds., Iustus Förlag 2005) and Bundgaard, *supra* n. 60.

83. A more appropriate definition may include the economic characteristics of the instruments and would not only rely on the tax law classification of the instruments. The difference is not of any legal significance, but, on a principled level, it seems more correct to include, in the definition of hybrid financial instruments, such instruments that are not necessarily classified differently in different countries but, in fact, do contain the economic terms and conditions that make the instrument a hybrid according to its economic nature.

being treated as “equity” for Danish income tax purposes. Danish tax law does not, however, in general, use the term “equity”. In fact, very few provisions make use of the term. The Danish Minister of Taxation, however, has stated that section 2 B will have an impact on all other Danish tax law provisions making use of the term “equity” such that reclassified debt instruments will also be considered equity according to such other provisions. It is specifically mentioned that reclassified debt instruments should be considered as equity under the Danish thin capitalization regime.

Based on a reading of the wording of section 2 B of the CTA, the provision will most likely be considered as exhaustive regarding the consequences of its application. Thus, equity treatment for tax purposes mostly implies dividend taxation and non-deductibility of interest payments and capital losses on debt. Given the narrow scope, the provision may be described as a system of partial reclassification. The immediate consequence of the dividend treatment of the yield of an HFI in Denmark is that a deduction is not allowed since dividends are not deductible.

It is also clarified that the consequences of the application of section 2 B extend to tax treaties, with the intention of creating symmetry between the Danish and foreign classification under tax treaties. A different treaty classification and treatment of interest and dividends under tax treaties does not have any consequences under Danish law due to the fact that the domestic provisions regarding withholding tax result in either full withholding tax or no withholding tax at all when the payment is covered by a tax treaty.

Finally, Danish tax law contains a specific provision according to which the scope of the participation regime is limited. This rule was actually introduced in 2006 as part of another provision with respect to declared dividends. The present provision in section 13 of the CTA was introduced in 2008 and is a specific limitation on the participation exemption regime. Accordingly, a participation exemption is not granted with respect to dividends that are deductible in the hands of the paying company, unless the country of residence of the paying company actually reduces or eliminates withholding tax on the payment in question in accordance with the EU Parent-Subsidiary Directive (2011/96). This broadly scoped provision seemingly will include most outbound HFIs that are treated as debt in the issuing country and as equity/dividends in Denmark at the level of a Danish parent company. Obviously, any analysis of the primary EU implications of this provision should rely on the actual scope. The author has previously claimed that the Parent-Subsidiary Directive should generally be applicable within the European Union irrespective of deductibility in the country of the paying company.⁸⁴ If this conclusion is correct and, furthermore, accepted by the Danish tax authorities, no such situations should occur within the European Union, where the provision may infringe the fundamental freedoms. Again it should be recalled that the freedom of capital may apply to portfolio investments in third countries, where the Danish coordination rules would also apply.

84. See Bundgaard, *Part 2, supra* n. 4, at p. 496.

5.2.4. Other countries

Application of the participation exemption regimes of Austria, Italy and New Zealand also requires that the dividend not be considered a deductible expense for the payor.⁸⁵

5.3. Scope of the TFEU

The establishment of subsidiaries that are subject to participation exemption regimes can be assessed on the basis of the freedom of establishment. The participation threshold has been gradually significantly lowered as part of a global trend. An example of this is seen in the EU Parent-Subsidiary Directive (2011/96) where the ownership threshold is now only 10% of the share capital of the distributing company. Consequently, the application of such regimes and the denial of an exemption can also be viewed as a capital movement, which is subject to the protection of the free movement of capital enshrined in article 63 of the TFEU. As a consequence of the latter, the EU law implications of coordination rules may also influence third-country relations.

Based on the above, the considerations on the scope of the freedom of establishment and the free movement of capital may be applicable to the situation at hand. Among the rules discussed earlier in section 4, only the Danish coordination rule in section 2 B of the CTA seems to be targeted only at groups of companies and can accordingly be viewed in the light of the free movement of establishment.

The above is not intended to present a detailed analysis of the applicable treaty provision. This would require a thorough analysis of the scope, wording and context of the domestic coordination rules in question.

5.4. The existence of a discriminatory or restrictive domestic measure

5.4.1. In general

Under a first step, an analysis is made of whether or not the national legislation in question establishes a restriction or even discrimination in respect of comparable situations. The comparability test is extremely important, as well as complex, in this context. It has not always been clear whether the ECJ is applying the discrimination test or the restriction test. The idea of a restriction is somewhat broader and covers more obstacles to the functioning of the internal market. Thus, it has not been clear in all cases whether the domestic tax provision in question actually resulted in discrimination (different treatment of comparable situations) or a restriction (impediment to the freedom of establishment or the free movement of capital).⁸⁶ The difference is said to influence the actual

85. See OECD, *supra* n. 61, at p. 19.

86. See, for example, N. Winther-Sorensen, *Skatteretten* 3, p. 414 et seq. (2005); S. van Thiel, *EU Case Law on Income Tax (Part 1)*, p. 450 (IBFD 2002) and *Free movement of Persons and Income Tax Law*, p. 319 et seq. (IBFD 2002); and B. Terra & P. Wattel, *European Tax Law*, p. 41 et seq. (Kluwer Law International 2012).

test under EU law.⁸⁷ More recent case law, however, raises doubts as to whether or not the ECJ will differentiate sharply between discrimination and restrictions when considering whether article 49 has been violated.⁸⁸

As a matter of practical interest it should be pointed out that the protection granted by the TFEU applies to taxpayers in the state of origin of the investment, as well as the company in the source state as long as both are established within the European Union/European Economic Area.⁸⁹ In the context of international corporate finance it may be relevant to consider whether any domestic tax legislation of a Member State impedes the possibilities for a company to attract capital (debt or equity) from companies in other Member States.

In particular, Advocate General Geelhoed has refined the discrimination test by stating that the fundamental freedoms apply where a different treatment of cross-border and purely domestic situations is not a direct and logical consequence of the fact that, in the present state of development of EU law, different tax obligations for subjects can apply in cross-border situations in comparison to purely internal situations. This means, according to the Advocate General, in particular, that, in order to fall under the fundamental freedoms, a disadvantageous tax treatment should follow from direct or covert discrimination resulting from the rules of one tax system, and not purely from *disparities or the division of tax jurisdiction* between two or more Member States' tax systems, or from the coexistence of national tax administrations. Such disparities or a division of tax jurisdiction is referred to by the Advocate General as "quasi-restrictions".⁹⁰

5.4.2. Restrictions caused by coordination rules disallowing the participation exemption – State of origin rules

If a domestic participation regime does not apply in the context of cross-border HFIs this may be said to constitute a restriction that is, in principle, prohibited by article 49 or article 63 of the TFEU. First it should be noted that, for legislation to be regarded as a restriction on the freedom of establishment, it is sufficient that it be capable of restricting the exercise of that freedom in a Member State by companies established in another Member State, without there being any need to establish that the legislation in question

87. See S. van Thiel, *EU Case Law on Income Tax (Part 1)*, supra n. 86, at p. 487 et seq. and *Free movement of Persons and Income Tax Law*, supra n. 86, at p. 531 et seq.

88. See, for example, *Lankhorst-Hohorst* (C-324/00); NL: ECJ, 12 Dec. 2002, Case C-385/00, *F.W.L. de Groot v. Staatssecretaris van Financiën*, ECJ Case Law IBFD; and *X&Y* (C-436/00).

89. See, for example, AT: ECJ, 15 July 2004, Case C-315/02, *Anneliese Lenz v. Finanzlandesdirektion für Tirol*, paras. 20 and 21, ECJ Case Law IBFD and *Manninen* (C-319/02), paras. 22-23.

90. See UK: Opinion of Advocate General Geelhoed, 23 Feb. 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, ECJ Case Law IBFD; FR: Opinion of Advocate General Geelhoed, 27 Apr. 2006, Case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, ECJ Case Law IBFD, and UK: Opinion of Advocate General Geelhoed, 29 June 2006, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, ECJ Case Law IBFD.

has actually had the effect of leading some of those companies to refrain from acquiring, creating or maintaining a subsidiary in the first Member State. It is, however, highly relevant to recall that the protection granted by the TFEU applies to taxpayers in the state of origin of the investment, as well as the company in the source state, as long as both are established within the European Union/European Economic Area.⁹¹

Comparability has to be established in order for a restrictive or discriminatory domestic practice to be found. This involves a decision on the comparator. The host and origin Member State perspective is explored by O'shea (2007) who summarizes the difference as follows:⁹²

[...] The distinction between "host" and "origin" Member State perspectives depends on whether the person exercising the Community law right is affected by a "host" Member State rule or an "origin" Member State rule. In relation to the former, the comparator is an "origin" Member State national in a similar situation who is not affected by the tax rule; in relation to "host" State Situations, the comparator is the person exercising the freedom compared with a national/resident in the "host" Member State in a comparable situation that is not disadvantaged by the "host" Member States' tax rule [...].

A vertical, as well as horizontal, comparison can be made according to ECJ case law concerning corporate taxpayers. According to the *vertical approach*, a comparison has to be made between a domestic parent company that establishes a subsidiary in a country that would allow a tax deduction for the distributions from the latter company to the parent company and a parent company that establishes a subsidiary in the state of residence of the parent company. According to the *horizontal comparison* the relevant test is to compare the tax treatment of a parent company that establishes a subsidiary in a country that would allow for a tax deduction for the distributions from the latter company to the parent company and a parent company that establishes a subsidiary in another Member State that does not allow such a treatment. In *A* (Case C-101/05), the ECJ compared dividend distributions from a company in a third country, as well as dividends from a company resident in another Member State and dividends from a company resident in the state of residence of the shareholder (Sweden).⁹³

In any event, the existence of a restriction and/or discrimination depends on whether the tax position of the group as a whole (the parent and the subsidiary) should be considered or whether the assessment should be carried out on a standalone basis. With respect to dividends in the source state and other areas of tax law, the Court prefers a "per country approach". This means that the Court is not willing to take into consideration the legal situation in other Member States in order to determine whether or not a tax provision infringes EU law.⁹⁴ As far as treatment in the

91. See, for example, *Lenz* (C-315/02), paras. 20 and 21 and NL: ECJ, Case C-35/98, *Staatssecretaris van Financiën v. B.G.M. Verkooijen*, paras. 34 and 35, ECJ Case Law IBFD.

92. T. O'shea, *EU Tax Law and Double Tax Conventions*, p. 34 et seq. and p. 220 (Avoir Fiscal Limited 2008).

93. See *A* (C-101/05), para. 41 et seq. with references.

94. See Lang, supra n. 35, at p. 72.

residence state is concerned, the ECJ seems to be willing to apply an “overall approach”, at least in specific circumstances.⁹⁵ In *Société de Gestion Industrielle SA (SGI)* (Case-311/08)⁹⁶ the ECJ rejected the idea of viewing the group as a whole. In paragraphs 51-52 the ECJ stated the following:

51. As regards the arguments relating to the tax treatment in a domestic situation of the income of the resident recipient company, it is apparent, as the Advocate General observed at point 45 of her Opinion, that the Governments in question base their observations on a global view of the group of companies and presume that it is irrelevant to which company within a group particular income is attributed.

52. In that connection, it should be noted that the resident company granting an unusual or gratuitous advantage and the recipient company are separate legal persons, both of which have their own individual tax liability. In any event, 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.

Taking the perspective of the standalone company, it would seem more straightforward that domestic provisions disallowing a participation exemption leave the domestic parent company in a worse tax situation than a company that receives non-deductible dividends from a domestic subsidiary or from a subsidiary in another Member State (i.e. applying the vertical, as well as the horizontal, approach). Taking the perspective of the group, as a whole, the group does not seem to be treated worse in a situation in which dividends are received from a subsidiary in a Member State that allows for a tax deduction for the dividends than if such dividends were received from either a domestic subsidiary or from a subsidiary that is resident in a Member State, where deduction is not accepted. In fact, the very idea behind coordination rules is to neutralize the beneficial effects of the possible asymmetrical tax treatment of the dividend in question and thereby link the tax position of one company to that of another. However, even in this scenario, an impediment might be imposed on the group if the tax value of a deductible dividend is less than the tax value of the participation exemption (for example, because the corporate tax rate of the payor is less than the corporate tax rate applicable to the parent company). Consequently, even in this scenario there may be a restriction.

According to the traditional restriction test, a parent company of one Member State may be said to be restricted from exercising the right to establish and maintain a subsidiary resident in another Member State in so far as dividends paid from the subsidiary are subject to a different tax treatment in the latter Member State. Further, it seems correct to assume that the coordination rules in question do not apply in a purely domestic context.

There are a number of general ECJ cases on dividend tax relief, including *Test Claimants in the FII Group Litigation Case* (C-446/04), *Lenz* (Case C-315/02) and *Manninen*. In paragraph 49 of the *FII* case, the case law was summarized as follows:

95. See Lang, *supra* n. 35, at p. 72. This is sometimes called the Internal Market Approach.

96. BE: ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*, ECJ Case Law IBFD.

[...] whatever the mechanism adopted for preventing or mitigating the imposition of a series of charges to tax or economic double taxation, 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 [...]⁹⁷

In the scenario analysed here there are obvious differences, the first being that a deduction at the level of the dividend paying company ensures that no double taxation actually takes place. Simultaneous application of a participation regime in the state of origin may lead to a double benefit in the form of deduction/non-inclusion for the group of companies as a whole. This is highlighted in the ECJ remarks in *Manninen* in paragraphs 34-36:

34. It is true that, in relation to such legislation, the situation of persons fully taxable in Finland might differ according to the place where they invested their capital. That would be the case in particular where the tax legislation of the Member State in which the investments were made already eliminated the risk of double taxation of company profits distributed in the form of dividends, by, for example, subjecting to corporation tax only such profits by the company concerned as were not distributed.

35. That is not the case here, however. As the order for reference shows, both dividends distributed by a company established in Finland and those paid by a company established in Sweden are, apart from the tax credit, capable of being subjected to double taxation. In both cases, the revenue is first subject to corporation tax and then – in so far as it is distributed in the form of dividends – to income tax in the hands of the beneficiaries.

36. Where a person fully taxable in Finland invests capital in a company established in Sweden, there is thus no way of escaping double taxation of the profits distributed by the company in which the investment is made. In the face of a tax rule which takes account of the corporation tax owed by a company in order to prevent double taxation of the profits distributed, shareholders who are fully taxable in Finland find themselves in a comparable situation, whether they receive dividends from a company established in that Member State or from a company established in Sweden.

Kollruss (2007) also analyses the question of compatibility.⁹⁸

Due to more recent ECJ case law developments it would, however, be troubling to find that there is a lack of comparability on the basis of a traditional vertical comparison. Thus, the ECJ refined its vertical method of comparison in *Cadbury Schweppes*. In that case, the outcome of the traditional vertical comparison was that there was no difference in treatment. In addition, the ECJ carried out a vertical comparison between (1) a UK parent company with a subsidiary in a Member State with a lower level of taxation according to the meaning of the UK CFC legislation and (2) a UK company with a subsidiary resident in a Member State with a level of taxation that is not lower than that required by the UK CFC legislation.⁹⁹ The coordination rules introduced are aimed at ensuring corporate taxation

97. See, for commentary, Denys, *supra* n. 27, at p. 221 et seq., emphasizing that in the context of prevention of multiple taxation, equal treatment means a tax credit or exemption that is no less favourable than that available for domestic sourced dividends. See further O’Shea, *supra* n. 27, at p. 887 et seq. and Vanistendael, *supra* n. 27, at p. 210 et seq.

98. Kollruss, *supra* n. 34, at p. 469.

99. *Cadbury Schweppes* (C-196/04), paras. 44-46.

of corporate income in the host state. If the yield of an HFI is taxed as interest in the state of residence of the investor the national anti-arbitrage provisions do not apply.

In *Banco Bilbao* (Case C-157/10)¹⁰⁰ the ECJ had to decide whether a domestic system (in Spain) disallowing domestic double taxation relief was limited to the foreign tax actually paid (in Belgium). The ECJ did not find such a measure to be in violation of EU law stating, inter alia, the following:

36. The national court considers that an interpretation of the provisions of the convention for the avoidance of double taxation and of Spanish national law to the effect that only tax actually paid in another Member State may be deducted from the tax due in Spain could discourage companies established in Spain from investing their capital in another Member State.

37. Consequently, it must be noted that the alleged disadvantage suffered by BBVA, in the present case, is not double taxation of the interest received by BBVA, as that interest was taxed solely in Spain, but the fact that it was not possible to benefit, for the purposes of calculating the tax due in Spain, from the tax advantage in the form of the exemption granted under Belgian law.

38. However, the Court has already ruled that the disadvantages which could arise from the parallel exercise of tax competences by different Member States, to the extent that such an exercise is not discriminatory, do not constitute restrictions on the freedom of movement [...]

39. Accordingly, if the 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.

In the context of HFIs, this case provides interesting input. The case demonstrates that a Member State clearly is not obliged to design its tax system such that taxpayers are able to benefit fully from the tax benefits obtained in other Member States. This is, however, not necessarily the same as concluding that Member States can freely design their tax systems in order to reduce the potential benefits of another Member State. Admittedly, there are some similarities in the situations, primarily in terms of the domestic limitations on participation exemption regimes when dividends are deductible in the source state. One difference is that the case concerned withholding tax and juridical double taxation and thereby the same taxpayer. The domestic system in Spain did not look to the tax treatment of another taxpayer when deciding whether or not a tax credit was available.

Nevertheless, it may be argued that the comparability test will always be passed and that the principle of equal treatment in the context of cross-border dividends applies irrespective of whether the risk of double taxation has been eliminated by allowing for a dividend deduction in the host state. It is settled case law that Member States cannot uphold tax disadvantages on the basis that tax benefits in other Member States *set off* the disadvantage. Moreover, it is settled case law that the national tax legislation in the

100. ES: ECJ, 8 Dec. 2011, Case C-157/10, *Banco Bilbao Vizcaya Argentaria SA v. Administración General del Estado*, ECJ Case Law IBFD.

state of origin cannot include requirements as regards the *level of taxation in the host state*. This was seen in the *Lenz* and the *Cadbury Schweppes* decisions. It is arguable that the deductibility of dividends or deductibility of payments that are classified inconsistently due to the application of different principles in the domestic tax legislation of Member States is merely a subset of the deviations that may have caused a company to be considered a low-tax company under the applicable CFC legislation of many Member States. Thus, at the end of the day, CFC taxation of foreign low-taxed companies and the exclusion of dividend payments from foreign companies on the basis that the payment is deductible can be seen as two sides of the same coin. Further, it may be argued that such anti-arbitrage legislation in fact – as was also the situation in *Cadbury Schweppes* – ensures taxation of corporate income at the level of the state of origin. This is also evidenced by the fact that the tax value of a deduction in the host state is not necessarily at the same level as the corporate tax rate in the parent company state.

German commentary has also focused on the correspondence principle (*Korrespondenzprinzip*) and its EU law conformity.¹⁰¹

It is not possible to conclude firmly whether or not, in principle, a Member State is allowed to exclude from the scope of the participation exemption regime certain dividend payments arising in a Member State in which the dividend payments are treated in a favourable manner that involves deductibility without violating the fundamental freedoms. In the view of this author, it is likely that the ECJ will find that such coordination efforts may be restrictive in the sense of the TFEU.

5.4.3. Restrictions caused by coordination rules disallowing an interest deduction – Host state rules

This type of legislation is an example of host state legislation. On the face of it, such national practices are similar to the practices decided on by the ECJ in the thin capitalization cases.¹⁰² Based on those cases, domestic reclassification of interest into dividends may constitute a violation of the freedom of establishment that can only be justified by the application of the arm's length principle. It should, however, be noted that the national legislation in question in the thin cap cases and the national legislation in question with respect to anti-arbitrage is not identical. In the thin cap cases, a purported loan granted by the investor is reclassified as dividends in the state of residence of the borrowing company resulting in an inconsistent classification that constitutes an obvious restriction with respect to establishing and maintaining a subsidiary in the state that imposes the different classification of the

101. Dörfler, Heurung & Adrian, *supra* n. 78, at p. 517 et seq. (footnotes omitted).

102. There is significant case law in the area of domestic thin capitalization rules, see *Lankhorst-Hohorst* (C-324/00), and *Thin Cap* (C-524/04). In *Lammers & Van Cleeff* (C-105/07), Belgian reclassification rules resulting in the reclassification of interest payments as loans from foreign directors (being companies) resident in another Member State was overruled by the ECJ.

purported loan. This is not the case when considering domestic coordination rules. According to such legislation, national reclassification is seen in the state of residence of the borrowing company but this reclassification does not result in a classification inconsistency from the perspective of the investor. In fact, the domestic reclassification from interest to dividends results in a classification consistency in line with the classification in the state of residence of the investor. Based on this, it may be argued that the potential investor is not restricted in any way with respect to exercising the freedom of establishment or the free movement of capital because the investor is treated in a manner that is similar to that which he would face if the investment were carried out within the borders of the state of residence of the investor (for example, a parent company).

It may be argued that Danish and UK companies are restricted in their access to debt financing from other Member States in so far as the state of residence of the investor treats the investment as equity. In this respect, it is once again relevant to consider the question of comparability from a host state perspective. Comparability has to be established in order for there to be a restrictive or discriminatory domestic practice. This involves a decision on the comparator. A vertical, as well as a horizontal, comparison can be made according to ECJ case law.^{103,104} If a vertical comparison is applied in this context, a comparison should be made between a debtor company with a foreign parent company and a debtor company with a domestic parent company. Such a comparison may lead to a conclusion that there is, in fact, a difference in the treatment if the parent company is a resident of a Member State that would treat the interest payments as dividends. Using the horizontal approach, there might be a difference between the tax treatment of a debtor company in, for example, Denmark or the United Kingdom (both being states that have introduced coordination rules disallowing interest deductions) depending on the state of residence of the creditor within the European Union.

Looking at a *group of companies as a whole*, a tax advantage can clearly arise as a consequence of the simultaneous application of different classification principles in different Member States. Based on this, it may be argued that the relevant comparison is a domestic group of companies that is subject to classification consistency and, further, that the domestic practices resulting in a reclassification of interest as dividends does not constitute a worse treatment of comparable situations.

In *Lankhorst-Hohorst*, the focus was on the single company level, namely the German subsidiary.¹⁰⁵ Here it was stated that the restriction introduced a difference in treatment between resident subsidiaries according to whether or not their parent company had its seat in Germany. The same

can be said with respect to the coordination rules in question. In *Rewe Zentralfinanz eG* (Case C-347/04),¹⁰⁶ the relevant comparison was made between German parent companies in paragraph 34. However, in *Manninen* the ECJ opened the door to looking at the overall tax position but did not find the requirements to be met in the actual case.¹⁰⁷ In *Marks & Spencer* (Case C-446/03), the ECJ also considered the group as a whole when analysing the question of comparability and found that the principle of territoriality could justify the difference in treatment.¹⁰⁸ Moreover, in *Test Claimants in the Thin Cap Group Litigation* (Case 524/04), the question of comparability was directly addressed within groups of companies. In paragraph 39 the ECJ stated that the national legislation was capable of increasing the tax liability of the borrowing company and in paragraph 40 that this gave rise to a difference in treatment between resident borrowing companies according to whether or not the related lending company was established in the United Kingdom. More specifically, regarding the question of comparability, the ECJ stated in paragraphs 59-60 that:

59. In that regard, it must be held, first, that the difference in treatment to which the subsidiaries of non-resident parent companies are, by virtue of legislation such as the legislation at issue in the main proceedings, subjected in comparison with subsidiaries of resident parent companies is capable of restricting freedom of establishment even if, from a tax perspective, the position of a multinational group of companies is not comparable to that of a group of companies, each of which is resident in the same Member State.

60. It is true that, within a group of companies, the risk that the financing of a subsidiary will be structured in such a way that profits are transferred to a State where they are subject to a lower rate of tax does not normally arise if all of the companies in question are subject, in the same Member State, to the same rate of tax. However, that does not mean that the rules adopted by a Member State for the specific purpose of dealing with the situation of multinational groups may not, in some cases, constitute a restriction on the freedom of establishment of the companies concerned.

Indicative of the winds blowing before the ECJ with regard to a restriction on deductibility when the recipient is not taxed on the payment is *Schempp* (Case C-403/03).¹⁰⁹ The situation at issue concerned Germany's refusal to regard the maintenance paid by Mr Schempp to his former spouse resident in Austria as a special expenditure that could be deducted for income tax purposes. The German tax authorities denied the deduction on the basis that Mr Schempp failed to produce a certificate from the Austrian tax authorities to show that his former spouse had been taxed in Austria on the maintenance payments as required under German tax law. Austrian law, however, excludes, in principle, the taxation of maintenance payments and does not allow for them to be deducted. A certificate thus could clearly not be produced in the case. The case was resolved on the basis of articles 12 and 18 of the TFEU. However, the decision contains some very pertinent observations in paragraphs 31-39:

103. See, regarding this distinction, Kollruss, *supra* n. 34, at p. 469 with further references to German commentary.

104. See, for example, regarding the comparability test applied by the ECJ, M. Lang in *Bilanz und Perspektiven zum europäischen recht*, p. 113 et seq. (A. Wagner & V. Wedl eds., Verlag des ÖGB 2007) and M. Lang, *Direct taxation: is the ECJ heading in a new direction?*, 46 Eur. Taxn. 9, p. 421 et seq. (2006), Journals IBFD.

105. *Lankhorst-Hohorst* (C-324/00), paras. 27 and 29.

106. DE: ECJ, 29 Mar. 2007, Case C-347/04, *Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte*, ECJ Case Law IBFD.

107. *Rewe Zentralfinanz* (C-347/04), paras. 34-37 and para. 46.

108. See *Marks & Spencer* (C-446/03), paras. 36-40.

109. DE: ECJ, 12 July 2005, Case C-403/03, *Egon Schempp v. Finanzamt München V*, ECJ Case Law IBFD.

31. It follows that since, in the main proceedings, the maintenance payments were not taxed in the Member State of residence of Mr Schempp's former spouse, he was not allowed to deduct those payments from his income in Germany.

32. In those circumstances, it is apparent that the unfavourable treatment of which Mr Schempp complains in fact derives from the circumstance that the tax system applicable to maintenance payments in his former spouse's Member State of residence differs from that applied in his own Member State of residence.

[...]

34. It is settled case-law that Article 12 EC is not concerned with any disparities in treatment, for persons and undertakings subject to the jurisdiction of the Community, which may result from divergences existing between the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality (see, to that effect, Case C-137/00 Milk Marque and National Farmers' Union [2003] ECR I-7975, paragraph 124 and the case-law cited there).

35. It follows that, contrary to Mr Schempp's claims, the payment of maintenance to a recipient resident in Germany cannot be compared to the payment of maintenance to a recipient resident in Austria. The recipient is subject in each of those two cases, as regards taxation of the maintenance payments, to a different tax system.

36. Consequently, the fact that a taxpayer resident in Germany is not able, under Paragraph 1a(1)(1) of the EStG, to deduct maintenance paid to his former spouse resident in Austria does not constitute discrimination within the meaning of Article 12 EC.

[...]

The fact that the *Schempp* case is based on article 18 of the TFEU on discrimination may have an impact on the relevance of the outcome of the case on coordination rules in general. Apart from this, the case may be seen as providing good arguments for the Member States in terms of disallowing interest deductibility on the basis on non-taxation in other Member States.

In *SIAT* (Case C-318/10),¹¹⁰ the ECJ decided on Belgian rules on the deductibility of business expenses. According to the Belgian rules, the deductibility, inter alia, of service fees was disallowed if the payments were made to a foreign enterprise that, according to the applicable rules of that country, was subject to a tax treatment that was significantly more favourable than the rules applicable in Belgium, unless the taxpayer proved, by any legal means, that such payments relate to genuine and proper transactions and do not exceed the normal limits.

SIAT was a Belgian company that established a joint venture subsidiary with a Nigerian group for the exploi-

110. BE: ECJ, 5 July 2012, Case C-318/10, *Société d'investissement pour l'agriculture tropicale SA (SIAT) v. Etat belge*, ECJ Case Law IBFD.

tation of palm plantations with a view to producing palm oil. Under the agreements between the parties, SIAT was to supply services in return for payment and to sell equipment to the joint subsidiary, but was required – as a commission for the introduction of the business – to give back part of the profit that it obtained from that subsidiary to the company heading the Nigerian group, namely, a Luxembourg company called Megatrade International SA (MISA). Noting that MISA had the status of a 1929 holding company and was, accordingly, not liable to pay any tax analogous to the corporation tax applicable in Belgium, the Belgian tax authority (the tax authority) applied article 54 of the 1992 Income Tax Code¹¹¹ and did not allow the sum of BEF 28,402,251 to be deducted as a business expense. The Court of First Instance, Brussels, upheld the tax authority's position. SIAT brought an appeal before the Belgian Court of Cassation, which decided to refer a question on the interpretation of article 49 of the TFEU for a preliminary ruling. The ECJ concluded that the Belgian rules in question, which laid down stricter conditions for being allowed to deduct business expenses than those laid down in the general rule and the scope of which have not been previously delimited with precision – are liable to dissuade Belgian taxpayers both from exercising their right to the freedom to provide services and from making use of the services of providers established in another Member State and to dissuade those providers from offering their services to recipients established in Belgium.¹¹²

This case is not similar to the coordination rules at question here. The Belgian case seems to deal with the issue of applying different criteria for obtaining the same tax benefit. The case contains no statement on whether or not it is acceptable to fully deny the tax benefit if the required documentation has not been provided.

In sum, no firm conclusion can be reached on whether or not, in principle, a Member State is allowed to restrict the deductibility of interest payments that are paid to another company that is a resident of a Member State in which the interest payments are treated in a favourable manner involving a tax exemption. In the view of this author, it is, however, likely that the ECJ will find that such coordination efforts may be restrictive in the sense of the TFEU. Against this background, part two of this article, to be published in issue 12 of *European Taxation* (2013) will analyse whether or not such a possible restriction can be justified by overriding reasons of public interest and whether such a restriction could be considered proportionate.

111. BE: Income Tax Code 1992, National Legislation IBFD.

112. See *SIAT* (C-318/10), para. 28.