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Discussion Paper Nr. 16

National Tax Policy, the Directives and Hybrid Finance

Eva Eberhartinger
Martin Six

FWF

National Tax Policy, the Directives and Hybrid Finance

Options for tax policy in the context of the treatment of Hybrid Financial Instruments in the Parent-Subsidiary Directive and the Interest and Royalties Directive

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A. Introduction

The right of legislation in the area of taxation is part of the sovereign right of each Member State, providing that State with autonomy of decision-making as regards its tax policy measures. This autonomy, however, is restricted by EU law in three ways:

1. Member States are bound by the Four Freedoms[1], and in the determination of those freedoms by the jurisdiction of the ECJ.[2]
2. Member States are subject to secondary EU Law in the form of regulations, directives and decisions.[3]
3. Member States are bound by the code of conduct for business taxation.[4]

The focus of this article rests on the effect of secondary EU Law, in the form of directives, on the autonomy of national tax policy in the Member States in the area of direct taxation. Up to now, directives have been a major tool used by the Council in bringing the national law of the Member States into line with the requirements of a common domestic market within the European Community.[5] Most of these directives contain very detailed provisions in order to achieve their intended goals[6]. Directives in the area of direct taxation, although few in number, are rather detailed and, thus, effectively constrain the Member States' autonomy in implementing tax policy. Nevertheless, apart from a wilful decision not to implement a directive, either in full or in part, some leeway remains for tax policy in the Member States in the course of the implementation of the directives.

It is the aim of this article to show that there is indeed room for tax policy in the Member States, taking the treatment of hybrid cross-border finance between associated companies as an example. We look at this in the context of the Parent-Subsidiary Directive (90/435/ECC) and the Interest and Royalties Directive (2003/49/EC). These directives have

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1 The free movement of goods (Art 23 et seq., ECT), the free movement of capital (Art 56 et seq., ECT), the free movement of services (Art 49 et seq., ECT), and the freedom of establishment (Art 39 et seq., ECT) within the internal market of the EU.

2 Art. 228, ECT; Cf. *Craig/De Búrca*, EU Law[3], Oxford 2003, 402 et seq.; *Callies/Ruffert (editors)*, Kommentar zu EU-Vertrag und EG-Vertrag[2], p. 1252 et seq.

3 Art. 249, ECT; Cf. *Craig/De Búrca*, EU Law[3], Oxford 2003, 112 et seq.; *Callies/Ruffert (editors)*, Kommentar zu EU-Vertrag und EG-Vertrag[2], p. 2171 et seq.

4 Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation, OJ C 002 , 6 January 1998.

5 Art. 94 of the EC Treaty gives the Commission the right to propose to the Council directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market. Cf. *Callies/Ruffert (editors)*, Kommentar zu EU-Vertrag und EG-Vertrag[2], p. 1252 et seq.; Cf. *Craig/De Búrca*, EU Law[3], Oxford 2003, p. 202, 1170, 1184; *Bieber/Epiney/Haag*, Die Europäische Union[6], p. 193 & p. 305 et seq.

6 Cf. *Prechal*, Directives in EC Law[2], Oxford 2005, p. 14 & 74; *Bieber/Epiney/Haag*, Die Europäische Union[6], p. 193 et seq.

been chosen, because they are interrelated, very detailed and have been implemented by the majority of the Member States.[7]

From the standpoint of the taxation of hybrid financial instruments, these are the most relevant directives, as hybrid financial instruments combine elements of debt and equity, by definition.[8] This means that the Member States' classification of the relevant instrument as equity or as debt, respectively, for domestic tax purposes, defines the yield as a dividend or as an interest payment. This, in turn, may or may not fall within the scope of application of the Parent-Subsidiary Directive or of the Interest and Royalties Directive. Since these classification issues have immediate consequences for the total amount of income taxes levied by the Member States concerned, we regard them as a good example in showing what can still be done by the Member States despite the EU directives. We will, therefore, concentrate on the options remaining for policy makers in the Member States in the following analysis, and examine the application of the terms dividend, interest and holding in capital on hybrid instruments in the course of the implementation of the aforementioned directives.

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[7] The Savings Directive (Council Directive on taxation of savings income in the form of interest payments, 2003/48/EC)) has not been included in the analysis, as its aim and scope of application are considerably different from those of the Parent-Subsidiary Directive and the Interest and Royalties Directive. Nevertheless, the Savings Directive will have an effect on the tax policy options of Member States as regards hybrid finance, where the yield of certain hybrid instruments received by individuals may qualify as interest in terms of the Directive. On the effect and the scope of application of the Savings Directive see e.g. *Bell*, EU Directive on the Taxation of Savings Income, IBFD DFI 2003, p. 201 et seq.; *Gläser*, Handbuch der EU-Quellensteuer, Wien 2006.

[8] Cf. *Larking*, IBFD International Tax Glossary[5], Amsterdam 2005, p. 212; *Duncan*, General Report, in *IFA,* Cahiers de droit fiscal international, Volume LXXXVa, Tax Treatment of hybrid financial instruments in cross-border transactions, Den Haag 2000, p. 22 et seq.; *Eberhartinger*, Hybride Finanzierungsinstrumente, in: *Bischof/Eberhartinger (editors)*, Hybride Finanzierungsinstrumente, Wien 2005, p. 121.

B. Hybrid Finance – The Problem

The compartmentalisation of company finance into equity and debt does not truly capture the enormous diversity of financial securities available. A wide variety of financial instruments incorporate elements of both equity and liability.[9] Usually, these financial instruments cannot be clearly attributed to either equity or debt and are, therefore, referred to as "hybrid"-instruments or mezzanine finance. The spectrum of hybrid instruments ranges from corporate shares with features typical of loans (such as certain preference shares) to loans with features usually associated with equity investments (such as participation in profit and loss). Such equity-type loans would include *inter alia* jouissance rights, silent partnerships, participation bonds, convertible bonds, warrant bonds, profit participation loans and preference shares.

The classification of such instruments as equity or debt may or may not be of particular interest from an investor's point of view, as hybrid instruments may be issued for a variety of non-tax reasons.[10] From a fiscal point of view, however, the classification as equity or debt is crucial for two reasons. First of all, the issuer can treat interest on the latter as tax-deductible in most cases, and secondly, for the investor the classification determines whether the payments received from the respective instrument is treated as a dividend or as interest.[11]

This classification for tax purposes is the source of important opportunities and risks in the area of international tax management, especially in international groups, where hybrid instruments can be used efficiently as flexible, tailor-made forms of finance. As long as no anti-avoidance rules, such as "Subject-To-Tax" Clauses are applicable, the qualification of the hybrid instrument as debt in the source state and as equity in the state of residence of the parent company could lead to double non-taxation of the profits. In such cases, the payment would then be deductible as interest in the source state and exempt as a dividend in the state of residence of the parent company. The opposite case, where the hybrid instrument is treated as equity in the source state and as debt in the state of residence of the parent company, might lead to double taxation, when the payment is subject to withholding tax in the source state and to income tax in the state of residence of the parent company.

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[9] Cf. the list of features of hybrid instruments that can blur the differentiation between equity and debt in *Duncan*, General Report, in *IFA,* Cahiers de droit fiscal international, Volume LXXXVa, Tax Treatment of hybrid financial instruments in cross-border transactions, Den Haag 2000, p. 24 et seq. and the various hybrid instruments analysed in the National Reports in the same Volume.

[10] For examples for such reasons see *Duncan*, General Report, in *IFA,* Cahiers de droit fiscal international, Volume LXXXVa, Tax Treatment of hybrid financial instruments in cross-border transactions, Den Haag 2000, p. 23.

[11] *Eberhartinger*, Hybride Finanzierungsinstrumente, in: *Bischof/Eberhartinger (editors)*, Hybride Finanzierungsinstrumente, Wien 2005, p. 122 with further references; *Duncan*, General Report, in *IFA,* Cahiers de droit fiscal international, Volume LXXXVa, Tax Treatment of hybrid financial instruments in cross-border transactions, Den Haag 2000, p. 27*; Helminen*, Classification of Cross-Border Payments on Hybrid Instruments, IBFD Bulletin 2004, p. 56; *Wittendorff/Banner-Voigt*, Taxation of Hybrid Instruments, IBFD DFI 2000, p. 3.

EC law does not affect the Member State's decision as to how to classify hybrid instruments for tax purposes, as long as the domestic law treatment does not constitute a forbidden discrimination or restriction under the EC Treaty.[12] EC law, however, may affect the tax treatment of the payments on such instruments *via* the directives[13].

For associated companies within the European Union using hybrid instruments, the definition of the payments received from, or paid on, hybrid instruments as dividends or interest, respectively, is therefore of particular relevance

- in respect of the differential treatment of dividends and interest payments in most national tax laws and double tax treaties, but also
- in respect of the decision whether or not those payments fall under the scope of the Parent-Subsidiary Directive, or the Interest and Royalties Directive, or neither.

Since the focus or our discussion rests on this second point, we will disregard the existence of double tax treaties between Member States for the purpose of this article, in order not to overcomplicate the analysis unduly. This limitation is in line with our aim to show options for tax policy despite these directives, since these are not influenced by double tax treaties. It is, therefore, possible to analyse separately the treatment of hybrid finance in the directives and in double tax treaties from a tax policy perspective.[14]

Furthermore, we chose to limit the analysis on the treatment of hybrid finance in the directives to cases where their use does not constitute fraud and abuse in domestic tax law. Therefore, we will not to go into detail on the implications of the general fraud and abuse provisions in Art 1 (2) of the Parent-Subsidiary Directive and Art 5 of the Interest and Royalties Directive for tax policy options in the context of hybrid finance.

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[12] E.g. *Helminen*, The Dividend Concept in international Tax Law, The Hague 1999, p. 266; Cf. the following examples of ECJ case-law on discrimination cases in connrction with dividend or interest payments: ECJ, 7 September 2004*, Case C-319/02, Petri Manninen*; ECJ, 15 July 2004, Case C-315/02, *Anneliese Lenz v Finanzlandesdirektion für Tirol*, ECJ, 4 March 2004, Case C-334/02, *Commission of the European Communities v. French Republic*; ECJ, 24 September 2003, Case C-168/01, *Bosal Holding BV v Staatssecretaris van Financiën*, ECJ, 12 December 2002, Case C-321/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*.

[13] Since this article only examines the treatment of hybrid finance between associated companies in EC Law, the Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments will not be taken into account in the analysis, since it only affects interest payments to individuals (Cf. Art. 2 (1), 2003/48/EC). For a comprehensive survey on the Savings Directive see e.g. *Bell*, EU Directive on the Taxation of Savings Income, IBFD DFI 2003, p. 201 et seq.; *Gläser*, Handbuch der EU-Quellensteuer, Wien 2005.

[14] For a comprehensive survey on the treatment of hybrid instruments in double tax treaties, see *Lang, M.*, Hybride Finanzierungen im Internationalen Steuerrecht, Wien 1991.

C. The Implementation of the directives into National Law

1. General Issues in the Implementation of EC directives into National Law

The Member States[15] are obliged to implement EC directives into national law in compliance with the fundamental provisions of the EC treaty[16], but have freedom of choice as regards the form and the methods to be used in realising the aims of the directive.[17] In this two-stage legislation process, the content of the final norm is defined by the institutions of the European Union, whereas the decision about the actual form lies in the competence of each Member State.[18] The provisions of a directive therefore do not replace existing national law, but oblige the Member States to adapt their laws to the provisions of the directive. The measures to be taken are at the discretion of the Member State and depend on the national legal system. According to *Prechal[19],* the Member States have a choice between *verbatim* transposition on the one hand, and translation of the directive into legal concepts and terminology on the other (plus all possible combinations of the two). As mentioned above, many directives are very detailed, thus leaving little room for the implementing authorities in respect of either the substance of the measure or its mode of implementation.[20]

All Member States are obliged to adapt their national law within the time limit in the directive.[21] These adaptations need to be conducted by a legal act of the same quality as the legal acts which are generally used on a national level in the area of the directive. The Member State must refer to the directive in these legal acts or in the official publication of those legal acts.[22]

Nevertheless, many countries do not implement the directives within the given time limits. On the contrary, in many cases Member States lag years behind those limits.[23] For this reason the question arises if citizens of the EU can appeal to the content of directives that have not

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15 Although directives, as opposed to regulations, do not have to be addressed to all Member States, most of them are addressed to all of them. Cf. *Craig/De Búrca*, EU Law[3], Oxford 2003, p. 114; *Prechal*, Directives in EC Law[2], Oxford 2005, p. 55 with further evidence.

16 See e.g. ECJ, 24 September 2003, Case C-168/01, *Bosal Holding BV v Staatssecretaris van Financiën*, in connexion with the implementation of the Parent Subsidiary Directive; Cf. with further references *Zanotti*, Taxation of Inter-Company Dividends in the Presence of a PE: The Impact of the EC Fundamental Freedoms, IBFD European Taxation 2004, p. 502.

17 Art. 249, III ECT.

18 Cf. *Haslach*, Die Umsetzung von EG-Richtlinien durch die Länder, Frankfurt 2001, p. 40, with further evidence.

19 *Prechal*, Directives in EC Law[2], Oxford 2005, p. 76.

20 Cf. *Prechal*, Directives in EC Law[2], Oxford 2005, p. 74.

21 This follows from Art. 10, I ECT. Before the time limit is reached, the directives already have legal effect insofar as the Member States "must refrain during that period from taking any measures liable seriously to compromise the result prescribed", ECJ, 18 December 1997, Case C-129/96, *Inter-Environnement Wallonie ASBL v Région wallonne*; Cf. *Prechal*, Directives in EC Law[2], Oxford 2005, p. 20; *Bieber/Epiney/Haag*, Die Europäische Union[6], p. 194.

22 See e.g. ECJ, 4 April 1974, Case C-167/73, *Commission of the European Communities v French Republic*; ECJ, 25 May 1982, Case C-96/81, *Commission of the European Communities v Kingdom of the Netherlands*; Cf. *Craig/De Búrca*, EU Law[3], Oxford 2003, p. 420. Bieber/Epiney/Haag, Die Europäische Union[6], p. 194.

23 Cf. *European Commission*, International Market Scoreboard 14, July 2005, 9 et seq.; *European Commission*, International Market Scoreboard 13, July 2004, p. 9 et seq.

been implemented in national law within the given time limits. In prevailing legal practise the European Court of Justice (ECJ) decided[24] that under certain circumstances the individual may rely on the provisions of the directive against the State (direct effect). Those circumstances are:[25]

- The provisions appear, as far as their subject is concerned, to be unconditional[26] and sufficiently precise.
- The State failed to implement the directive in national law by the end of the period prescribed or failed to implement the directive correctly.

2. The Status of Implementation of the Parent-Subsidiary Directive and the Interest and Royalties Directive.

The following chart shows the status of implementation of the original Parent-Subsidiary Directive, the 2003 Directive Amending the Parent-Subsidiary Directive and the Interest and Royalties Directive. The data on the Parent-Subsidiary Directive is based on entries in the EUR-Lex Database before 4 July, 2006.[27] The data on the Interest and Royalties Directive is based on the Survey on the Implementation of the EC Interest and Royalty Directive carried out by the International Bureau of Fiscal Documentation (IBFD) published on the homepage of the Commission by 2 June, 2006.[28]

[24] Cf. e.g. ECJ, 5 April 1979, Case C-148/78, Pubblico Ministero v Tullio Ratti; ECJ, 26 January 1984, Case C-301/82, *SA Clin-Midy and others v Belgian State*; ECJ, 26 February 1986, Case C-152/84, *M. H. Marshall v Southampton and South-West Hampshire Area Health Authority (Teaching)*; ECJ, 23 February 1994, Case C-236/92, Comitatio di Coordinamento per la Difesa della Cava and others v. Regione Lombardia and others; ECJ, 11 August 1995, Case C-431/92, *Commission of the European Communities v Federal Republic of Germany* ("Großkrotzenburg"), Cf. also *Craig/De Búrca*, EU Law[3], Oxford 2003, p. 202 et seq.; on the supremacy of EC law see e.g. ECJ, 15 July 1964, C-6/64, *Flaminio Costa v E.N.E.L.*; *Craig/De Búrca*, EU Law[3], Oxford 2003, p. 186 et seq. & 275 et seq.

[25] Cf. *Prechal*, Directives in EC Law[2], Oxford 2005, p. 20.

[26] A provision is unconditional where it is not subject, in its implementation or effects, to the taking of any measure either by the institutions of the Community or by the Member State. See ECJ, 23 February 1994, Case C-236/92, *Comitatio di Coordinamento per la Difesa della Cava and others v. Regione Lombardia and others.*

[27] Note that the fact that there is a reference in the EUR-Lex to measures of national implementation does not necessarily mean that these measures are either comprehensive, or in conformity with the directive.

[28] http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/survey_IR_dir.pdf

Table 1: Status of implementation of the directives

Member State / Directive	90/435/EEC	2003/123/EC	2003/49/EC
Belgium	✓	✓	✓
Czech Republic	✓	✓	✓
Denmark	✓	✓	✓
Germany	✓	✓	✓
Estonia	✓	✓	✓
Greece	✓	*	✓
Spain	✓	*	✓
France	✓	✓	✓
Ireland	✓*	✓*	✓*
Italy	✓*	*	✓
Cyprus	✓	✓	✓
Latvia	✓	✓	✓
Lithuania	✓	✓	✓
Luxembourg	✓*	*	✓
Hungary	✓	✓	✓
Malta	✓	✓	✓
Netherlands	✓*	*	✓
Austria	✓	✓	✓
Poland	✓	✓	✓
Portugal	✓	✓	✓
Slovenia	✓	✓	✓
Slovak Republic	✓	✓	✓
Finland	✓	✓	✓
Sweden	✓*	✓*	✓
United Kingdom	✓**	✓**	✓

* No reference available in the EUR-Lex database. In these cases the information given is based on the online editions of IBFD, Europe – Company Taxation 2005 and IBFD, EC Corporate Tax Law, 2005.

** Since UK tax law largely satisfies the Parent-Subsidiary Directive the only implementation legislation was to remove the charge to UK tax on paying agents which potentially conflicts with Art 6 of the directive. See *Tomsett*, County Chapter United Kingdom, recital 82 et. seq. in**:** *IBFD*, EC Corporate Tax Law, 2005.

D. The Parent-Subsidiary Directive

1. The Aims of the Parent Subsidiary Directive

The Council Directive 90/435/ECC on the common system of taxation applicable to parent companies and subsidiaries of different Member States (the Parent-Subsidiary Directive) was adopted on 23 June 1990 and was to be implemented by the Member States by 1 January 1992.

The Parent-Subsidiary Directive is part of the general process of approximating the conditions within the EU to those of a single domestic market, to ensure the effective functioning of the common market.[29] The right of the Council to issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market derives from Art 94 ECT.[30] In such a market it is considered necessary by the Council of the European Communities to allow enterprises to adapt to the requirements of the common market, to increase their productivity and to improve their competitive strength on an international level by grouping together companies of different Member States, without any restrictions, distortions or disadvantages arising from the tax provisions of the Member States.[31]

The establishment of a subsidiary in another Member State usually results in a corporate tax liability of the subsidiary in this Member State. It may result in additional corporation tax on dividends received by the parent company in its state of residence, once the subsidiary's profit is distributed. Thus, the profit would be taxed twice if no measures were taken. While the corporation tax levied on a subsidiary within the same state is frequently accounted for in the calculation of the corporation tax of the parent, this is often impossible or at least not possible to the same extent, when the subsidiary is situated in another state. This leads to double taxation of the distributed income of the subsidiary in all those cases where no double-taxation treaties exist. Furthermore, the source state generally levies a withholding tax on the profits. This leads, in the absence of a double-taxation treaty, to an additional double taxation of the profits since the parent company effectively has to pay company tax to its state of residence and withholding tax to the state of residence of the subsidiary.[32] If these

[29] On the general issues of the completion of the single market within the EU in a legal context and the scope of application of Art. 94 ECT cf. *Craig/De Búrca*, EU Law[3], Oxford 2003, p. 1170 et seq., especially p. 1186; Cf. *Meerpohl*, Die Mutter-/Tochter-Richtlinie der Europäischen Gemeinschaft und ihre Umsetzung in das Recht der Mitgliedstaaten, Frankfurt 1998, p. 26 et seq. on the legal basis for the approximation of company taxes in the EU.

[30] Cf. *Callies/Ruffert (editors)*, Kommentar zu EU-Vertrag und EG-Vertrag[2], p. 1252 et seq.; Cf. *Craig/De Búrca*, EU Law[3], Oxford 2003, p. 202, 1170, 1184; *Bieber/Epiney/Haag*, Die Europäische Union[6], p. 193 & p. 305 et seq.

[31] Cf. 90/435/ECC, 22.09.1990, OJ L 225, p. 6.

[32] See Chapter C, Section 2.

combined effects appear, they represent an infringement of the principle of non-discrimination and the freedom of establishment[33].

Against this background the original Parent-Subsidiary Directive was designed to eliminate those tax obstacles in the process of the distribution of profits (dividends) from subsidiary to parent within the EU by

- abolishing withholding taxes on distributed profits between associated companies[34] of different Member States in the source state, and
- preventing double taxation of parent companies on the profits of their subsidiaries.

On 22 December 2003, the Council adopted Directive 2003/123/EC[35] to broaden the scope and improve the operation of the Parent-Subsidiary Directive, by updating the list of companies that the directive covers, relaxing the conditions for exempting profits from withholding tax (reduction of the participation threshold) and eliminating double taxation for subsidiaries of subsidiary companies.[36]

2. The Effect of the Parent-Subsidiary Directive

In implementing the Parent-Subsidiary Directive the Member States could choose between exempting from tax the profits received by the parent company, or giving credit for tax already paid.[37] Every Member State except for Malta,[38] Poland,[39] and the UK,[40] opted for the exemption system for profits within the scope of the directive.[41] For this reason the focus lies on the exemption method to show the tax effect of the Parent-Subsidiary Directive.

The following chart shows the effect of the Parent-Subsidiary Directive on the total tax burden borne by dividends received by the parent company, compared to the tax burden

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33 Art. 12 & Art. 43 ECT, Cf. *Meerpohl*, Die Mutter-/Tochter-Richtlinie der Europäischen Gemeinschaft und ihre Umsetzung in das Recht der Mitgliedstaaten, Frankfurt 1998, p. 33; on the principle of non-discrimination see at length *Craig/De Búrca*, EU Law[3], Oxford 2003, p. 387 et seq. with further references.

34 The Directive also applies to profits paid to or received by a permanent establishment of a company of a Member State in another Member State. A permanent establishment is defined in Art. 2(2) of the Directive as a fixed place of business situated in a Member State through which the business of a company or another member state is wholly or partly carried on in so far as the profits of that place of business are subject to tax in the Member State in which it is situated by virtue of the relevant tax treaty or, in the absence of such a treaty, by virtue of national law. See *Distaso/Russo*, The EC Interest and Royalties Directive – A Comment, IBFD Euopean Taxation 2004, p. 145, for a detailed discussion of the term permanent establishment.

35 Council Directive 2003/123/EC, 22.12.2003, OJ L 7.

36 Cf. *Brokelind*, The Proposed Amendments to the Parent-Subsidiary Directive: Some Progress?, IBFD European Taxation 2003, 451 et seq.

37 Cf. Art. 4 (1) of the Directive; *Terra/Wattel*, European Tax Law[4], The Hague, p. 504 et seq.

38 Cf. *Manduca*, Country Chapter Malta, recital 73 et seq. in: *IBFD*, EC Corporate Tax Law, 2005.

39 Cf. *Krempa*, Country Chapter Poland, recital 251 et seq. in: *IBFD*, EC Corporate Tax Law, 2005.

40 Cf. *Tomsett*, Country Chapter United Kingdom, recital 77 et seq. in: *IBFD*, EC Corporate Tax Law, 2005.

41 Note that in the Estonian tax system incoming dividends are never subject to corporation tax. Instead they are taxed when redistributed by the parent company. To avoid double taxation on the incoming dividends in these cases, credit relief is given for the foreign tax paid. Cf. *Riikjärv/Linnamägi*, Country Chapter Estonia, recital 786 et seq. in: *IBFD*, EC Corporate Tax Law, 2005.

without the directive under the (imaginary worst case) assumption of no double-taxation treaty between the two States involved. It is also assumed that the State of the parent company does not provide any unilateral double-taxation relief measures. Corporation tax rates and withholding tax rates in both countries are assumed to be 25%.

Table 2: Tax effect of the Parent-Subsidiary Directive

	before Parent-Subsidiary Directive	**after Parent-Subsidiary Directive**
SOURCE STATE:		
EBIT	100,000	100,000
Deductible Interest	0	0
EBT	100,000	100,000
Corporate Tax (25 %)	**-25,000**	**-25,000**
Distributable Profit after Corporate Tax	75,000	75,000
Withholding Tax (25 %)	**-18,750**	**0**
Dividends paid	56,250	75,000
PARENT STATE:		
Dividends received	56,250	75,000
Tax Base for Corporate Tax	75,000	75,000
Corporate Tax (25 %)	**-18,750**	**0**
Income after Tax	37,500	75,000
Total Tax Burden	**62,500**	**25,000**

3. The Scope of the Parent Subsidiary Directive

The following analysis of the scope of the directive shall be limited to those provisions and definitions which are of relevance to the discussion of the treatment of payments on hybrid instruments. Since it makes no difference to our discussion whether the distributed profits flow to, or from, a permanent establishment provided the requirements of the directive are met, the analysis will concentrate on the case of payments between associated companies.[42]

3.1. Company of a Member State

The Parent-Subsidiary Directive applies to Companies which

- take one of the forms listed in the Annex of the directive

[42] For a comprehensive survey on the definition and the scope of application of the term permanent establishment in EC Law, see *Thömmes/Eicker*, The Taxation of Permanent Establishments, EC Law aspects of permanent establishments, Amsterdam, loose-leaf. For a detailed analysis of the cases covered by the Parent-Subsidiary Directive in the presence of a permanent establishment before and after the amendment through Council Directive 2003/123/EC see *Zanotti*, Taxation of Inter-Company Dividends in the Presence of a PE: The Impact of the EC Fundamental Freedoms, IBFD European Taxation 2004, p. 503, with further evidence.

- are resident in a Member State for tax purposes according to the tax laws of this State and are not, under the terms of a doubletaxation agreement concluded with a third State, considered to be resident for tax purposes outside the Community, and
- are subject to one of the taxes (all of them corporate taxes) listed in Article 2(c) of the directive, without the possibility of an option, or of being exempt.

As a result of this last provision, partnerships are generally exempt from the benefits of the directive, even if they are entitled to opt for a corporation-tax liability. Companies which are liable for corporation tax in principal, but do not actually pay such a tax due to certain tax exemptions, are nevertheless subject to the directive.[43]

3.2. Parent Company

According to Art 3 (1) of the original Parent-Subsidiary Directive a parent company is a company which fulfils the conditions set out in Art 2 and has a minimum holding of at least 25% in the capital of a company in another Member State fulfilling the same conditions. This minimum requirement has been changed through the last amendment of the Parent-Subsidiary Directive in December 2003. The limit is now 20% and will be lowered gradually to 10% by 1 January 2009 (01.01.2005: 20%, 01.01.2007: 15%, 01.01.2009: 10%).

The term "holding in the capital" itself is not defined in the directive. This gives Member States an opportunity to include or exclude other forms of participation, apart from classic shares in equity, in the determination of the holding level required in the national implementation of the directive (as for example indirect participation via an intermediary).

According to Art 3 (2) Member States have the option to replace the criterion of a holding in capital by that of a holding of voting rights, by means of bilateral agreements. They also have the option of not applying the directive to companies, (a) which do not maintain holdings qualifying them as parent companies for an uninterrupted period of at least two years, or (b) to those of their companies in which another Member State does not maintain such a holding for an uninterrupted period of at least two years.

3.3. Profits

The Parent-Subsidiary Directive itself contains no definition of the term profits, but merely states that the Member State shall apply this directive to distributions of profits (Art 1 (1), 90/435/ECC). Moreover, the state of residence of the parent company (and the state of its permanent establishment) shall refrain from taxing such distributed profits (Art 4 (1),

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[43] For a detailed analysis of Art. 2(c) see *Meerpohl*, Die Mutter-/Tochter-Richtlinie der Europäischen Gemeinschaft und ihre Umsetzung in das Recht der Mitgliedstaaten, Frankfurt 1998, p. 58.

90/435/ECC) and that profits, which a subsidiary distributes to its parent company, shall be exempt from withholding tax (Art 5 (1), 90/435/ECC).

Unquestionably the term distributed profits includes dividends which, in turn, is a term that is difficult to define[44]. Although the terms dividends and distributed profits are often used synonymously, the latter has a broader scope including other profit distributions as well. In the introduction to directive 2003/123/EC the Council of the European Communities itself states that the objective of the Parent-Subsidiary Directive is to exempt "*dividends and other profit distributions*". The term profit distribution therefore can be interpreted to cover any payment based on the shareholder-company relationship or the association between companies.[45] The directive leaves it to the Member states and their national definitions to decide which profits to include within the scope of the national application of the directive.

From the wording of the directive it is unclear whether profits on liquidation, and disguised profits, fall within the scope of the term profit distributions in the Parent-Subsidiary Directive as well. Profits on the liquidation of a subsidiary are specifically exempt from the scope of application of the directive, which seeks to prevent the double taxation of parent companies on the profits of their subsidiaries (Art 4). However, these liquidation profits are not exempt from the directive with regard to the abolition of withholding taxes on payments of profits in the source state. Consequently, profits on the liquidation of the subsidiary would have to be exempt from the withholding tax as well.[46] On the treatment of disguised profits, the directive contains no rules, thus leaving it to the Member States whether or not to include disguised profits.[47]

[44] Cf. the preliminary remarks to the OECD Commentary on article 10 of the OECD Model Convention concerning the taxation of dividends according to which by "dividends" is generally meant the distributions of profits to the shareholder by companies limited by shares, limited partnerships with share capital, limited liability companies or other joint stock companies, but which also states (Section 23) that "in view of the great differences between the laws of OECD Member countries, it is impossible to define dividends fully and exhaustively".

[45] Cf. *Helminen*, Classification of Cross-Border Payments on Hybrid Instruments, IBFD Bulletin 2004, p. 60; Since the Parent-Subsidiary Directive does not employ the term dividend as in Art. 10, Section 3 of the OECD Model Convention, the definition of the term dividend in the OECD Commentary on Article 10 can only be applied conditionally to the term profit distributions in the Parent-Subsidiary Directive.

[46] Cf. *Meerpohl*, Die Mutter-/Tochter-Richtlinie der Europäischen Gemeinschaft und ihre Umsetzung in das Recht der Mitgliedstaaten, Frankfurt 1998, p. 50; *Terra/Wattel*, European Tax Law[4], The Hague, p. 514.

[47] According to *Terra/Wattel* (European Tax Law[4], The Hague, p. 514) the term distributed profits encompasses disguised profits, which would therefore have to be subject to the benefits of the Directive as well. Note that the commentary on Art 10 of the OECD Model Tax Convention states that the term dividends may include disguised distributions of profits. See commentary on OECD Model Tax Convention, recital 28.

E. The Interest and Royalties Directive

1. The Aims of the Interest and Royalties Directive

The Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments between associated companies in different Member States (the Interest and Royalties Directive) was adopted on 3 June 2003 and was to be implemented by the Member States by 1 January 2004.

The primary aim of this directive is to ensure that associated companies in different Member States are not discriminated against relative to associated companies in the same Member State through less favourable tax conditions than those applicable to parent/subsidiary structures within a Member State. It therefore serves as an instrument to harmonise income taxes within the EU domestic market.[48] The Interest and Royalties Directive was considered necessary by the Council of the European Communities, because national tax laws and bilateral agreements, in the form of double-taxation treaties, are not always sufficient to eliminate the double taxation of those payments, and often entail burdensome administrative formalities, cash flow problems and a loss of interest for the companies involved.[49]

For example, should a Member State, in which the Company which pays interest and royalties is based (source state[50]), impose a withholding tax on interest payments that exceeds the amount of income tax the receiving company has to pay in the other Member State and (according to the double tax treaty or national tax law) this Member State grants a tax credit for the withholding tax, the receiving company (beneficial owner[51]) can only utilise part of the total amount of the tax withheld in the sources state as tax credit (or none, if the taxable income is zero). Additionally the receiving company will have a loss of interest for the time between receiving the net payments (less the withholding tax) and the credit of the withholding tax.[52]

To achieve equal treatment of interest and royalty payments between associated companies[53] in the EU the directive ensures that such payments are subject to tax only in the

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48 Cf. fn 4.

49 See Para. 2 of the preamble to Council Directive 2003/49/EC, OJ L 157, 26.6.2003, p.49. *Tumpel*, Neuer Vorschlag der Kommission für eine Richtlinie über die Besteuerung von Zahlungen für Zinsen und Lizenzgebühren; SWI 1998, p. 211; *Terra/Wattel*, European Tax Law[4], The Hague, p. 625 et seq.

50 Art. 1 (2), Council Directive 2003/49/EC.

51 Art. 1 (4), Council Directive 2003/49/EC, Cf. Chapter D, Section 3.1.

52 For the same reasons the credit method itself is often considered to violate the fundamental freedoms. See e.g. *Vogel*, Which Method Should the European Community Adopt for the Avoidance of Double Taxation, IBFD Bulletin 2002, 4; *Schönfeld, J.*, Hinzurechnungsbesteuerung zwischen Steuerwettbewerb und Europäischen Grundfreiheiten, StuW 2005, 160; *Cordewener*, A*./Schnitger, A.*, Europarecht und Vermeidung der internationalen Doppelbesteuerung im Wege der Anrechnungsmethode, StuW 2006, 56.

53 The Directive also applies to interest or royalties paid to, or received by, a permanent establishment of a company of a Member State in another Member State. See Chapter D, Section 3.4.

Member State of the beneficial owner. The source state has to exempt those payments from tax, including withholding tax.

2. The Effect of the Interest and Royalties Directive

The following chart shows the effect of the Interest and Royalties Directive on interest received by the parent company, compared to the tax burden in the absence of the directive, on the (imaginary worst case) assumption that there was no double-taxation treaty between the two Member States involved, and that the Member State of the parent company did not provide any unilateral double-taxation relief measures. Corporation tax rates and withholding tax rates in both countries are assumed to be 25%.

Tablet 3: Tax effect of the Interest and Royalties Directive

	before Interest and Royalties Directive	**after Interest and Royalties Directive**
SOURCE STATE:		
EBIT	100,000	100,000
Deductible Interest	-100,000	-100,000
EBT	0	0
Corporate Tax (25 %)	**0**	**0**
Distributable Profit after Corporate Tax	100,000	100,000
Withholding Tax (25 %)	**-25,000**	
Interest Paid	75,000	100,000
PARENT STATE:		
Interest Received	75,000	100,000
Tax Base for Corporate Tax	100,000	100,000
Corporate Tax (25 %)	**-25,000**	**-25,000**
Income after Tax	50,000	75,000
Total Tax Burden	**50,000**	**25,000**

3. The Scope of the Interest and Royalties Directive

As with the Parent-Subsidiary Directive the following analysis of the scope of the directive is limited to those provisions and definitions which are of relevance to the discussion of the treatment of hybrid finance in the directives. Again, the discussion does not include payments to/from permanent establishments, due to lack of relevance to our analysis. We focus on payments between associated companies.[54]

[54] See *Distaso/Russo* (The EC Interest and Royalties Directive – A Comment, IBFD European Taxation 2004, p. 145) for a detailed discussion of the term permanent establishment used in the Interest and Royalties Directive. For a comprehensive survey on the definition and the scope of application of the term permanent establishment in EC Law, see *Thömmes/Eicker*, The Taxation of Permanent Establishments, EC Law aspects of permanent establishments, Amsterdam, loose-leaf.

3.1. Associated Companies

As under the Parent-Subsidiary Directive, the benefits of the Interest and Royalties Directive are only granted to companies which are

- of a type listed in the annex to the directive,
- tax resident in an EU Member State and
- subject to corporation tax in the EU

if, at least

- the first company has a direct minimum holding of 20 % in the capital of the second company, or
- the second company has a direct minimum holding of 20 % in the capital of the first company, or
- a third company has a direct minimum holding of 20 % both in the capital of the first company and in the capital of the second company.[55]

Holdings must involve only companies resident in Community territory.

The annex to the directive originally included the types of companies which existed in the 15 Member States that were already members of the EU before 1 May 2004. The types of companies in the new Member States within the scope of the directive have been added by Council Directive 2004/66/EC of 26 April 2004.[56] Furthermore, the Commission proposed an amendment to Directive 2003/49/EC on 30 December 2003[57] to provide for an update of the list of companies in the annex to the directive. This new list would also include;

- the European Company (*Societas Europaea)*[58]
- the European Co-operative Society[59]

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55 The Directive does not apply to interest paid by a company located in a Member State to its grandparent company located in another Member State. See *Distaso/Russo* (The EC Interest and Royalties Directive – A Comment, IBFD European Taxation 2004, p. 145) who also discuss the problem of interest paid via fiscally transparent partnerships.

56 OJ L168, 1.5.2004, p. 67; In addition, the Council, on 29 April, adopted Directive 2004/76/EC (Official Journal L 157, p. 106) on the basis of the Commission's proposal of 1 April 2004 (see COM(2004) 243 final), granting some of the new Member States transitional periods resulting in their not applying the provisions of the Directive immediately from the date of their accession.

57 COM(2003) 841 final - see also press release at IP/04/105.

58 Council Regulation (EC) 2157/2000; Council Directive 2001/86/EC, see also press release IP/01/1376.

59 Council Regulation (EC) 1435/2003; Council Directive 2003/72/EC, see also press release IP/03/1071.

3.2. Beneficial Owner

According to Art 1 (4) of the directive, a Company of a Member State[60] is treated as the beneficial owner of interest and royalties only if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory, for some other person.[61]

The term “for its own benefit” is not defined in the directive, which only states that intermediaries, agents, trustees or authorised signatories do not receive payments for their own benefit. *Distaso/Russo*[62] assume that providing the recipient has been remunerated at arm’s length, it should be entitled to the benefits of the directive. Therefore, a company in a Member State which receives a loan from a company outside the EU and then, in turn, lends this money to one of its subsidiaries in another Member State, will be entitled (provided all other requirements are met) to the benefits from the Interest and Royalties Directive for the interest received from this subsidiary, as long as both deals are conducted at arm’s length. Although it could be argued that the company in that example only acts as an intermediary in terms of Art 1 (4) and, therefore, does not qualify as beneficial owner in terms of the directive, *Distaso/Russo* seem to be correct in assuming that the definition of the term beneficial owner in the directive covers such cases as well.[63]

3.3. Interest and Royalties

Art 2 of the directive provides the definition of the terms interest and royalties.[64] It reads as follows:

> *The term "interest" means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. In particular, it covers all income from securities, bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment are not regarded as interest.*[65]

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[60] For a critical examination of the differing definition of the term beneficial owner in the case of a permanent establishment see *Distaso/Russo*, The EC Interest and Royalties Directive – A Comment, IBFD European Taxation 2004, p. 148.

[61] For a comprehensive discussion of the meaning of the term beneficial owner, also in respect to the relation of the OECD Model Tax Convention and the EC Directives see e.g. *Oliver* et al., Beneficial Ownership, 54 Bulletin for International Fiscal Documentation 7/2000, p. 310.

[62] *Distaso/Russo*, The EC Interest and Royalties Directive – A Comment, IBFD European Taxation 2004, p. 148.

[63] *Distaso/Russo* (The EC Interest and Royalties Directive – A Comment, IBFD European Taxation 2004, p. 148) further state, that only purely artificial transactions should be excluded from the application of the Directive by this definition, although they do not define the term *purely artificial transactions*. Reversing their example, a purely artificial transaction would be one where one of the deals is *not* conducted at arm’s length.

[64] Since it is of no importance for hybrid cross border finance the definition of the term royalties shall not be discussed in this article.

[65] Art. 2, Council Directive 2003/49/EC.

This definition is the same as in Art 11 of the 2005 OECD Model Tax Convention.[66] The directive in Art 4, however, allows Member States to exempt certain payments from the benefits of the directive. Those benefits are:

- Payments which are treated as a distribution of profits or as a repayment of capital under the law of the source country.
- Payments from debt-claims which carry a right to participate in the debtor's profits.
- Payments from debt-claims which entitle the creditor to exchange his rights to interest for a right to participate in the debtor's profits.
- Payments from debt-claims which contain no provision for repayment of the principal amount or where the repayment is due more than 50 years after the date of issue.

It is up to each Member State to decide, which of these four cases will be excluded from the scope of the directive. The aim of this option seems to be to provide Member States with a tool to counteract the abuses of the directive, through disguising distributions of profit or returns on the provision of equity as interest within the definition of the directive and to avoid major distortions of the national tax system.

[66] *OECD*, Model Tax Convention on Income and Capital, 15 July 2005.

F. Hybrid Finance in the directives

1. Hybrid Finance under the terms of the Parent-Subsidiary Directive

As explained above, the Parent-Subsidiary Directive applies to profit distributions to a parent company in one Member State by its (associated) subsidiary in another Member State. In the context of hybrid finance two questions arise:

- Do payments on hybrid instruments qualify as distributed profits in terms of Art 1 of the Parent-Subsidiary Directive at all, and if so, which instruments would have to be included?
- Does participation via hybrid instruments attribute to the holding level required by the Parent-Subsidiary Directive in Art 3 at all and if so, which instruments would have to be included?

In answering these questions one will find out about the discretionary leeway of Member States when implementing the directive.

To answer these questions, it is necessary once again to have a look at the aims of the Parent-Subsidiary Directive, which is essentially the elimination of double taxation in the relations between parent companies and subsidiaries in context with hybrid finance.

Should the state of residence of the subsidiary (source state) classify a hybrid instrument as equity and, thus, deny a (tax) deduction on the payments on the instrument and levy a withholding tax, double taxation would be the result whenever the state of residence of the parent company (residence state) qualifies the hybrid instrument as equity as well. In this case, the payments would be subject to corporation tax in both countries and to withholding tax in the source state.[67] Since the purpose of the directive is precisely to eliminate such cases of double taxation,[68] the directive has to be applied in these situations.[69] This means, that payments on hybrid instruments, which are deemed returns on equity investment and, therefore, as dividends by the source state, would always have to be subject to the benefits of the Parent-Subsidiary Directive. Member States could, therefore, determine which hybrid instruments would benefit from the Parent-Subsidiary Directive *via* their treatment in national tax law.

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[67] See Chapter C, Section 3 for the effect on the total tax burden on payments.

[68] Cf. the preamble to 2003/123/EC and the preamble to 90/435/EEC; *Helminen*, The Dividend Concept in International Tax Law, The Hague 1999, p. 266.

[69] See *Terra/Wattel*, European Tax Law[4], The Hague, p. 514 et seq.; *Helminen*, Classification of Cross-Border Payments on Hybrid Instruments, IBFD Bulletin 2004, p. 60; *Helminen*, The Dividend Concept in International Tax Law, The Hague 1999, p. 266. Also see chapter B on the Member States obligation to implement the directive according to the objectives specified by the Council.

In this regard, it is interesting to have a look at the origins of the Interest and Royalties directive:[70]

The last section of Art 4 of the *Proposal* for the Interest and Royalties Directive[71], which contains an option for Member States to exempt certain payments from the benefits of the directive, indicates that this interpretation corresponds to an (at least originally) intended interrelation between the two directives. It reads as follows:

> *Interest that has been re-characterised as a distribution of profits shall accordingly be subject instead to the provisions of Council Directive 90/435/EEC (The Parent-Subsidiary Directive), where it is paid between companies to which the present Directive applies.*

The commentary on the Proposal for the Interest and Royalties Directive stated that such a switch in the applicable directive could arise, if for example the re-characterisation as a distribution of profits follows from a tax treaty between two Member States or is based on the domestic tax law of the source state.[72]

The proposed text seems to refer primarily to thin capitalisation and disguised dividends. As *Helminen*[73] correctly states, one could deduce from these text passages that the Commission was of the opinion that income from hybrid instruments should usually qualify as a profit distribution under the Parent-Subsidiary Directive, if treated as a dividend in the source state or if treated as a dividend for tax treaty purposes. The logical consequence of this opinion is that payments on hybrid instruments between companies which fulfil the requirements of both directives[74] are either subject to the Parent-Subsidiary Directive or to the Interest and Royalties Directive, depending on the treatment in the tax law of the source state or in the tax treaties between those countries.[75]

Interestingly though, the reference to the Parent-Subsidiary Directive is not included in the final legal version of the Interest and Royalties Directive. This raises the question whether, in the opinion of the Commission, payments on hybrid instruments that have been excluded from the benefits of the Interest and Royalties Directive on the basis of Art 4(a) as profit

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[70] Cf the procedure files of the European Parliament on the Parent-Subsidiary Directive (CNS/1993/1205 and CNS/2003/0179).

[71] COM (1998) 67 final, OJ C 123/9. Cf. *Helminen*, Classification of Cross-Border Payments on Hybrid Instruments, IBFD Bulletin 2004, p. 60.

[72] Commentary on Art. 4 of the Proposal for the Interest and Royalties Directive, COM (1998) 67 final. 8

[73] *Helminen*, Classification of Cross-Border Payments on Hybrid Instruments, IBFD Bulletin 2004, 60.

[74] For example the minimum requirements for the holding in capital under both directives would have to be fulfilled, which would be the case anyway, if the parent company held more than 25% in the capital of the subsidiary. Cf. Chapters C and D for the scope of the directives.

[75] This opinion seems to be confirmed by Para. 19 of the Commentary on Art. 11 of the OECD Model Tax Convention 2005 which in the context of thin capitalization cases states that, “it should be noted that the term “interest” as used in Art. 11 does not include items of income which are dealt with under Art. 10”.

distributions, necessarily qualify as profit distributions in the terms of the Parent-Subsidiary Directive; otherwise, they need not fall within the scope of either of these directives.[76]

From our point of view it seems reasonable to assume that the benefits of the Parent-Subsidiary Directive should always be applicable to payments on hybrid instruments in the national implementation of a Member State, if this Member State treats such payments as dividends under national tax law. In any case the Member State would be hard put to argue why these payments, representing dividends in national tax law, should be exempt from the benefits of the directive.[77] Consequently profit distributions on hybrid instruments, which are qualified as interest in the Member State, should not benefit form the Parents-Subsidiary Directive.

Assuming that payments on such hybrid instruments should be treated as profits under the terms of the Parent-Subsidiary Directive, the question arises whether these hybrid instruments should then be included in the determination of the holding level required for the status of a parent company in the terms of the directive. Again the directive itself contains no definition of the term “holding in capital”[78], which gives Member States the freedom to define the term in the national implementation of the directive and, therefore, the option to include or exclude certain hybrid instrument. This option however can only go so far, because the payments on the relevant hybrid instrument are treated as profit distributions under the terms of the directive. Therefore, the problem can be narrowed to the question whether hybrid instruments, whose payments qualify as profit distributions under the directive, have to be included in the determination of the minimum holding requirement for the implementation of the directive, or whether the Member States enjoy some discretion in the matter. *Helminen*[79] reasonably argues that, if hybrid debt is treated as equity, it would also have to be taken into account in calculating the fulfilment of the holding requirement between two countries for the purpose of the directive.

If the source state must grant the benefits of the Parent-Subsidiary in cases where hybrid instruments qualify as equity in national tax law, the question arises whether the state of residence of the parent company has to grant these benefits symmetrically, thereby accepting the classification of the source state. If it does not, but treats the hybrid instrument as debt instead, the profits distributed by the subsidiary would be subject to income tax in the state of the recipient. In this case, it would be possible for the residence state to levy income tax on the profits distributed by the subsidiary, even though the source state applies the Parent-Subsidiary Directive. It clearly cannot be required of the parent state to accept the

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76 See Chapter E, Section 3 for tax policy issues in this context.
77 Cf. *Helminen*, Classification of Cross-Border Payments on Hybrid Instruments, IBFD Bulletin 2004, p. 60.
78 See Chapter C, Section 3.1.
79 *Helminen*, The Dividend Concept in international Tax Law, The Hague 1999, p. 267.

qualification of the source state in any case, but *Helminen*[80] seems to be correct in arguing that it should at least do so in the following two cases:

- If, in the opposite situation, the recipient's state of residence itself would have qualified the hybrid instrument as equity.
- If it the recipient's state of residence has to accept a treatment as equity for tax treaty purposes.

2. Hybrid Finance in the Scope of the Interest and Royalties Directive

As explained in Chapter D, the Interest and Royalties Directive contains on the one hand a very wide definition of the term interest ("Income from debt claims of any kind"), and on the other allows Member States to deny the application of the directive in the four cases listed in Art 4, thus enabling them to narrow the definition of interest for the purpose of the directive considerably. From the perspective of hybrid finance these four specific cases are of special relevance, since they mainly apply to hybrid instruments. They shall therefore be analysed separately:

Art 4(a) allows the source state to exempt payments which are treated as a distribution of profits or as a repayment of capital under its domestic law from the benefits of the directive. From the perspective of hybrid finance (e.g. jouissance rights which are treated as equity in the source state) this provision is especially interesting, since the author's share the view that these payments, if the option is executed and provided the other requirements are met, should fall under the scope of application of the Parent-Subsidiary Directive.[81] As mentioned above, this connection was explicitly stated in the Proposal for the Interest and Royalties Directive in 1998[82] and it is not apparent why this statement was not included in the final version of the directive.

Presuming that any payments which qualify as profit distributions under the tax law of the source state fall under the scope of the Parent-Subsidiary Directive, the question arises as to what happens if the source state does not execute the option in Art 4(a) of the Interest and Royalties Directive and if these payments fall under the scope of both directives.[83] Since both directives prescribe an exemption from any withholding tax on the payments, the effect on the tax burden would be the same, but it nevertheless seems interesting that under these circumstances the same payment might qualify as interest and as profit distribution.

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[80] *Helminen*, The Dividend Concept in international Tax Law, The Hague 1999, p. 269.

[81] See Chapter E, Section 3.1.; Cf. *Distaso/Russo*, The EC Interest and Royalties Directive – A Comment, IBFD European Taxation 2004, p. 150; *Helminen*, Classification of Cross-Border Payments on Hybrid Instruments, IBFD Bulletin 2004, p. 60;

[82] COM (1998) 67 final, OJ C123/9.

[83] Again provided all other requirements are met.

Apart from these considerations, it seems to be the case that, although the provision of Art 4(a) (in the context of the sovereignty to qualify a given instrument as equity or debt) allows the Member States to deprive certain hybrid instruments from the benefits of the Interest and Royalties Directive, the effect on tax revenue would be nil, because these instruments would subsequently fall under the application of the Parent-Subsidiary Directive. In our opinion it can be assumed that this was indeed the intention of the Commission, as the requirements of a common single market are then fulfilled.[84] The question remains, why Art 4(a) of the directive gives the Member States an option instead of generally exempting such payments from the scope of the directive.

Art 4 (b) allows the exemption of debt-claims which carry a right to participate in the debtor's profits.[85] These include participation bonds and profit participation loans as well as forms of jouissance rights and silent partnerships which are qualified as debt. The source state, therefore, has the option to exclude jouissance rights and silent partnerships form the scope of application of the Interest and Royalties Directive as well as the Parent-Subsidiary Directive by first qualifying them as debt on a national level, thus exempting them from the benefits of the Parent-Subsidiary Directive, and then using the option in Art 4 (b) to exempt them from the benefits of the Interest and Royalties Directive.

Art 4 (c) refers to convertible debt instruments, which "entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits". Literally interpreted this wording does not include hybrid instruments, such as convertible bonds and warrant bonds which grant the right of conversion into share capital of the creditor. The question is, if Art 4 (c) is indeed meant to include only interest bearing loans with an option to exchange the entitlement to interest against the entitlement to profit participation, or if the term "a right to participate in the debtor's profits" is used as an equivalent for the term "a right to participate in the debtor's equity" which would include hybrid instruments like convertible bonds or warrant bonds.[86]

Art 4 (d) finally allows the exemption of debt-claims which from an economic point of view serve as equity, because they contain no provision of repayment of the principal amount or a provision where the repayment is due more than 50 years after the date of issue.

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[84] Cf. Para. (1) of the Preamble to the Interest and Royalties Directive and Para. (1) of the Preamble to the Parent-Subsidiary Directive.

[85] Since Art. 4 (b) refers only to participation in the debtor's profits a literal interpretation would mean that interest payments connected to another entity, e.g. a subsidiary of the debtor, would not be included in the option. Cf. *Distaso/Russo*, The EC Interest and Royalties Directive – A Comment, IBFD European Taxation 2004, p. 150.

[86] *Distaso/Russo* (The EC Interest and Royalties Directive – A Comment, IBFD European Taxation 2004, p. 150) plead for a literal interpretation of Art. 4 (b) on the grounds that the provisions in Art. 4 are meant to be exceptions from the general rule of application in Art. 2 (1) and that a broader interpretation of the exceptions in Art. 4 therefore would run the risk of frustrating the Directive.

Art 4 (b), (c) and (d) all apply to cases where the treatment under the domestic tax law of the source state corresponds to the general definition of interest in Art 2 (1) of the directive. This means that Member States can decide to exempt payments on certain (hybrid) financial instruments from the benefits of the directive, while still qualifying the same payments as interest in domestic tax law. The reason behind these provisions is hard to see, since it seems to foil the general aim of the Interest and Royalties Directive, which is to eliminate double taxation on interest payments.[87]

Distaso/Russo[88] argue that the intention behind these provisions might be to give Member States a tool to eliminate cases of double non-taxation, by excluding instruments that create a tax deduction in the source state, while giving rise to an exemption from taxation of the corresponding income received, because the residence state of the recipient treats the income as profit distributions. If this were indeed the case, the provisions in Art 4 seem to be a rather inadequate instrument since the directive affects not only payments between one pair of Member States, but all payments within its scope. Apart from that, Art 4 includes no reference to the treatment of the payments in the residence state of the recipient. It is therefore possible for the source state to exempt payments from the scope of the directive which are treated symmetrically as interest in both states, thereby creating double taxation instead of avoiding double non-taxation, specifically.

The bottom line, nevertheless, is that the directive leaves room for national tax policy measures in the Member States to exempt hybrid instruments from the scope of application of the directive altogether, without having to include them in the scope of the Parent Subsidiary Directive.

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[87] See Chapter D, Section 1.

[88] *Distaso/Russo*, The EC Interest and Royalties Directive – A Comment, IBFD European Taxation 2004, p. 150.

G. Conclusion

EC-Law restricts fiscal sovereignty and, therefore, the possibilities for tax policy on the part of the Member States. The goal is to ensure the establishment and effective functioning of the common market, by approximating the conditions within the European Union to those of a domestic market.

The directive is a major tool of the Council in bringing the national law of the Member States into line with the conditions of such a domestic market. It stands to reason to assume that the more detailed a certain directive is, the less discretionary freedom remains for tax policy in the Member States.

This assumption has been tested for the Parent-Subsidiary Directive and the Interest and Royalties Directive as applied to the tax treatment of hybrid finance. These directives were chosen because they are interrelated, very detailed and have been implemented by most Member States. Furthermore, they are of particular importance for national tax policy in direct taxation as they influence attempts to encourage equity finance, and collide with the ambition to safeguard national tax revenue. It is therefore of great interest for the Member States to know what can still be done in terms of tax policy in spite of these directives.

The leeway for tax policy in the context of the Parent-Subsidiary Directive seems rather limited. Assuming that payments on hybrid instruments are treated as returns on equity by the source state, and therefore as dividends in terms of the directive, such payments have always to be subject to the benefits of the Parent-Subsidiary Directive. The only way for a Member States to circumvent the directive then is *via* a general, national classification of a certain hybrid instrument as debt. But then, however, the hybrid instrument would come under the terms of the Interest and Royalties Directive. This means that no withholding tax could be levied on the payments to those hybrid instruments as long as the source state did not execute any of the options in Art 4 of the Interest and Royalties Directive. For the parent state on the other hand, a classification as debt in terms of the Interest and Royalties Directive, instead of equity in terms of the Parent-Subsidiary Directive, would mean that it was still possible to levy corporation tax on the payments received.

The Interest and Royalties Directive provides considerably more leeway for tax policy. Art 4 of the directive allows Member States to deny the application of the directive in four specific cases, which encompass several forms of hybrid finance. This enables the Member State to levy withholding tax on certain hybrid instruments despite the directive. While this seems clear cut in the case of Art 4 (b-c), there is some doubt in the case of Art 4 (a) where payments, which the source state chooses to exempt because they are treated as a

distribution of profits or as a repayment of capital under its domestic law, should subsequently fall under the scope of application of the Parent-Subsidiary Directive. This would be the case in the circumstances mentioned above, i.e. where payments on hybrid instruments which are treated as equity in the source state, have always to come under the sway of the Parent-Subsidiary Directive. The source state would not then be allowed to levy withholding taxes, irrespective of the national qualification of the hybrid instrument, provided Art 4 (b-c) is not applicable. If, on the other hand, payments on such instruments did not qualify as dividends in terms of the Parent-Subsidiary Directive, Art 4 (a) as well as Art 4 (b-c) provide the source state with an option of levying withholding tax in certain cases of hybrid finance in spite of the directives.

Should the aim of its tax policy in a Member State be in opposition to the directives, i.e. if national tax policy were aimed at safeguarding national tax revenue in the area of hybrid finance (rather than simplifying its tax procedures for domestic companies or to create incentives for foreign investment), it seems that a Member State to a certain extent could adhere to

- its right to levy withholding tax (as a source state) and
- its right to levy corporation tax (as a parent state),

in spite of the directives. This could be achieved by treating, or classifying, hybrid financial instruments, in general, as debt under national tax law.

Whether this would be a good strategy for Member States to pursue is another matter, but it certainly shows, that the main objective of the two directives – the elimination of double taxation in the area of dividend and interest payments – has not been achieved to a hundred percent so far. Thus it seems that the use of directives, even very detailed ones, as a tool for harmonisation in the area of direct taxation limits options for national tax policy considerably, but does not eliminate them altogether.