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Article (Draft)

Original Citation:

Rust, Alexander (2015) BEPS Action 2: 2014 Deliverable Neutralising the Effects of Hybrid Mismatch Arrangements and its compatibility with the non-discrimination provisions in tax treaties and the Treaty on the Functioning of the European Union. *British Tax Review* (3). pp. 308-324. ISSN 0007-1870

This version is available at: <http://epub.wu.ac.at/5466/>

Available in ePub^{WU}: March 2017

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BEPS Action 2: 2014 Deliverable Neutralising the Effects of Hybrid Mismatch Arrangements and its compatibility with the non-discrimination provisions in tax treaties and the Treaty on the Functioning of the European Union ¹

This article illustrates the BEPS proposals to fight against hybrid mismatch arrangements. It concentrates on exemption / non-inclusion schemes and double deduction schemes and analyses whether these proposals are in line with the non-discrimination provisions contained in tax treaties and in the TFEU. The article comes to the conclusion that the proposals generally comply with the non-discrimination provisions. However, with regard to double deduction schemes the OECD proposes to deny a deduction in the permanent establishment state if the payments are also deductible in the head office state. In the author's opinion this recommendation conflicts with the freedom of establishment contained in the TFEU.

1. Introduction

The Organisation for Economic Co-operation and Development (OECD) published its Report "Neutralising the Effects of Hybrid Mismatch Arrangements Action 2: 2014 Deliverable" on September 16, 2014.² Its suggestions rely on the Report of March 5, 2012 on "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues"³, the Base Erosion and Profit Shifting (BEPS) Report "Addressing Base Erosion and Profit Shifting" of February 12, 2012⁴ and the BEPS "Action Plan on Base Erosion and Profit Shifting" of July 19, 2013.⁵ This article illustrates some of the proposed hybrid mismatch rules and analyses whether these rules are in line with the requirements of tax treaty and EU law. The article starts with the proposals to tackle deduction and non-inclusion

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² OECD Report of September 16, 2014 *Neutralising the Effects of Hybrid Mismatch Arrangements, ACTION 2: 2014 Deliverable* OECD/G20 Base Erosion and Profit Shifting Project, (BEPS Action 2 Deliverable Report) (Paris: OECD Publishing 2014).available at:

<http://dx.doi.org/10.1787/9789264218819-en> [Accessed May 26, 2015].

³ OECD Report of 5 March 2012, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*, (Paris, OECD Publishing , 2012) available at:

http://www.oecd.org/ctp/aggressive/HYBRIDS_ENG_Final_October2012.pdf. [Accessed May 26, 2015].

⁴ OECD Report of 12 February 2012, *Addressing Base Erosion and Profit Shifting*, (Paris, OECD Publishing , 2012) available at: [http://www.oecd-](http://www.oecd-ilibrary.org/docserver/download/2313151e.pdf?expires=1422471561&id=id&accname=ocid177428&checksum=159224BE66F3B7D656AAD29A8A8D7AE9)

[library.org/docserver/download/2313151e.pdf?expires=1422471561&id=id&accname=ocid177428&checksum=159224BE66F3B7D656AAD29A8A8D7AE9](http://www.oecd-ilibrary.org/docserver/download/2313151e.pdf?expires=1422471561&id=id&accname=ocid177428&checksum=159224BE66F3B7D656AAD29A8A8D7AE9). [Accessed May 26, 2015].

⁵ OECD Report of 19 July 2013, "Action Plan on Base Erosion and Profit Shifting", (Paris, OECD Publishing , 2013) available at: [http://www.oecd-](http://www.oecd-ilibrary.org/docserver/download/2313331e.pdf?expires=1422471469&id=id&accname=guest&checksum=4E2859B8AA78EE1DEBC92C76A5FA15D1)

[library.org/docserver/download/2313331e.pdf?expires=1422471469&id=id&accname=guest&checksum=4E2859B8AA78EE1DEBC92C76A5FA15D1](http://www.oecd-ilibrary.org/docserver/download/2313331e.pdf?expires=1422471469&id=id&accname=guest&checksum=4E2859B8AA78EE1DEBC92C76A5FA15D1). [Accessed May 26, 2015]. For EU measures to fight against hybrid

mismatch arrangements see European Commission of 6 December 2012, Action Plan to strengthen the fight against tax fraud and tax evasion, COM(2012) 722 final; European Commission of 6 December 2012, Recommendation on aggressive tax planning, COM(2012) 8806 final; see also the changes made by the **Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States**.

schemes making use of hybrid financial instruments and then examines the suggestions made concerning double deduction schemes.

2. Deduction / Non-Inclusion Schemes

2.1. Tax Planning Opportunities

In the second chapter of the Report, the OECD addresses tax planning arrangements where the taxpayer obtains a tax deduction for payments in one state without having to include the payment in the tax base in another state. The easiest way to set up a deduction / non-inclusion scheme is to establish a company in a tax haven. If this company grants a loan to a company located in a high tax country the interest payments are deductible in the high tax country while the payments are subject to no or only to a low taxation at the level of the company in the tax haven. A similar result can be obtained through the use of special tax regimes. Many high tax countries grant special tax privileges for certain types of income. For example, patent box regimes have become popular during recent years.⁶ The Netherlands, for example, tax corporate income at a rate of between 20 per cent and 25 per cent. Income covered by the “Innovatiebox” (innovation) regime are only subject to a tax rate of 5 per cent. Royalty payments for the use of a patent reduce the tax base of the company.

The OECD Report deals with several situations where the taxpayer uses a hybrid financial instrument to obtain a deduction for interest payments in one country and an exemption for dividends in another country because the instrument is characterized as debt in the former and as equity in the latter country.⁷ For financial instruments some countries follow a more formalistic approach while other countries apply a substance over form approach. Due to these different approaches it is possible that a hybrid financial instrument which has elements of a debt instrument and elements of an equity instrument will be characterised differently.

The same benefit of deduction/non-inclusion can also be achieved through investment via a partnership.⁸ In some countries partnerships are treated as transparent entities and their profits are taxed at the level of the partners. In other countries partnerships are treated as non-transparent entities and the profit is taxed at the level of the partnership. The partners are only taxed if the

⁶ A good overview of the different patent box regimes is given by L.Evers, H.Miller, C.Spengel, “Intellectual Property Box Regimes: Effective Tax Rates and Tax Policy Considerations,” *International Tax and Public Finance* June 2015, Volume 22, Issue 3, pp 502-530, available for download at: <http://link.springer.com/article/10.1007%2Fs10797-014-9328-x> [Accessed May 27, 2015].

⁷ OECD BEPS Action 2 Deliverable Report, above fn.2, para 52; for the distinction between equity and debt see J.A. Duncan, “Tax treatment of hybrid financial instruments in crossborder transactions”, *IFA Cahiers de droit fiscal international*, Vol. LXXXVa (The Hague: Kluwer Law International, 2000), p. 22 et seq. and the respective national reports; Schön et al, “Debt and Equity in Domestic and International Tax Law – A Comparative Policy Analysis” [2014] BTR 146.

⁸ OECD BEPS Action 2 Deliverable Report, above fn.2, para 72.

partnership's profit is distributed to them. If persons who are resident in a country which treats partnerships as transparent entities set up a partnership in another country which treats partnerships as non-transparent entities then a qualification conflict will arise. If the partners grant a loan to their partnership the interest payments are deductible at the level of the partnership as the partnership state regards the partnership as a taxable entity in that state. For the partners the interest payments are, however, not taxable as the loan is ignored in the state in which the partners are resident as that state will regard it as a transaction between two parts of the same taxpayer. If the partnership does not have any additional positive income the interest expenses can be used for tax purposes via a group regime. A deduction / non-inclusion scheme can also be achieved if three countries are involved:⁹ Two corporations which are resident in State A treating partnerships as non-transparent set up a partnership in State B which regards partnerships as transparent. As a next step the partnership grants a loan to a corporation resident in a third State C which treats partnerships as non-transparent entities. From the perspective of State A and State C interest is paid from a corporation in State C to another taxable entity located in State B. State C will grant a deduction for the interest payments and State C will not tax the payments as they are sheltered by the taxable entity in State B. From the perspective of State B, however, the partnership is not a taxable entity. As long as the partnership does not constitute a permanent establishment in its territory State B will not tax the interest payments. As a result, State C will grant a deduction while neither State B nor State A will tax the payments.

2.2. Proposals to tackle tax planning arrangements based on hybrid instruments and hybrid entities

The most effective way to avoid these qualification conflicts would be the harmonisation of the tax laws in the countries concerned. If all countries had the same rules for the distinction between equity and debt qualification conflicts would no longer arise. Tax planning arrangements involving hybrid entities could also be tackled if all countries treated partnerships either as transparent or non-transparent entities. However, even within the EU it is not very probable that countries will be willing to harmonise their tax rules.¹⁰ The OECD proposes a linking rule to solve qualification conflicts. Each country should adapt its tax rules to the tax treatment in the other country. If one country treats a payment either as interest or as a dividend the other country should follow that approach. As it is unlikely that all countries will adopt this approach the OECD addresses both countries to make sure one of the two countries involved will implement the OECD recommendations.¹¹

⁹ OECD BEPS Action 2 Deliverable Report, above fn.2, para 80.

¹⁰ For example, the proposal for a Council Directive on a Common Consolidated Corporate Tax Base dates from 2011 and it is unclear whether it will be enacted in the nearby future.

¹¹ OECD, BEPS Action 2 Deliverable Report, above fn.2, para 60.

According to the OECD, it is the country in which the payment is made that should adapt its tax rules to the rules of the country in which the recipient of the payment is located. The OECD labels this the “primary response”: a country should disallow a deduction for a payment if the payment is exempt from tax in the country of the recipient. If, however, the country where the payment is made does not disallow the deduction for the payment then it is the task of the country in which the recipient is located to tax the payment and not to apply its exemption system. This linking rule requires an extensive exchange of information, as countries have to know the tax rules concerning the distinction between debt and equity, the deductibility of interest payments and the exemption for dividends of all other countries involved.

2.2.1. Primary Response

The “primary response” – denying the deductibility of interest payments if the payments are tax exempt in the recipient country – has already been implemented in Austria. In accordance with Sec. 12(1) N°10 Austrian Corporate Income Tax Act (CITA), interest payments are not deductible at the level of the payer if the payments are made to a foreign corporation, the paying and the receiving corporation belong to the same group and the payment is not taxed at the level of the receiving company due to an exemption.¹² In Germany, the Federal Council wanted to introduce a similar provision disallowing the deduction of interest payments if the country of the recipient does not characterise the income as interest.¹³ This provision, however, did not enter into force.

Disallowing the deduction of interest payments neither violates the tax treaty non-discrimination provisions nor the fundamental freedoms of the **Treaty on the Functioning of the European Union** (TFEU).

2.2.1.1. Compatibility of the “primary response” with Article 24(4) **OECD Model Tax Convention**

¹² See Beiser, *Ausgewogene Aufteilung der Ertragsteuerbefugnis und Abzug von Schuldzinsen und Lizenzgebühren*, SWI 2014, 261; Dziurdz/Marchgraber, *Überlegungen zum konzerninternen Abzugsverbot für “niedrig besteuerte” Zinsen und Lizenzgebühren*, ÖStZ 2014, 378; Peyerl, *Das neue Abzugsverbot für Zins- und Lizenzzahlungen im Konzern*, ÖStZ 2014, 223; Polivanova-Rosenauer, *AbgÄG 2014: Abzugsverbot für Zinsen und Lizenzgebühren*, taxlex 2014, 105; Wimpissinger, *Ist die Nichtabzugsfähigkeit von Zinsen und Lizenzgebühren nach § 12 KStG unionsrechtswidrig?*, SWI 2014, 220.

¹³ The proposal of a new Sec. 4(5a) ITA had the following wording: Expenses are not deductible if they are tax exempt at the level of the recipient due to a different characterisation of the loan in the recipient country.” (Author’s translation); see Kahlenberg, *Neue Beschränkungen des Zinsabzugs: Regelungsempfehlungen gegen doppelte Nichtbesteuerungs- und Double-Dip-Strukturen*, ISR 2014, 91; Linn, *Zum Entwurf einer Betriebsausgabenabzugsbeschränkung im Zollkodex-Anpassungsgesetz*, IStR 2014, 920.

The non-deductibility of interest payments does not conflict with tax treaties that contain a provision similar to Article 24(4) OECD **Model Tax Convention** (MC).¹⁴ Article 24(4) OECD MC provides:

“4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 10 of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.”

According to this provision, a Contracting State may not discriminate against its own resident enterprises just because they make a payment to a non-resident. Payments made to an enterprise of the other Contracting State must be deductible under the same conditions as payments made to domestic enterprises. Article 24(4) OECD MC prohibits all discriminations which are based on residence of the recipient of the payments. A distinction based on criteria other than residence is still permitted.¹⁵ In the case of the primary response the denial of the deduction is not based on residence of the enterprise. The reason for the non-deductibility is that the payments are tax exempt at the level of the recipient company. One could argue that residence in the other Contracting State and tax exemption of the payments are linked: in general, if the recipient is a company resident in the other Contracting State the payments will be regarded as dividends and are, therefore, tax exempt. However, residence in the other Contracting State is neither a necessary nor a sufficient condition. If the payment is made to another resident enterprise which has a permanent establishment in the other Contracting State and the payments are attributable to the permanent establishment the payments will not be deductible either as they are tax exempt at the level of the permanent establishment. By contrast, if the recipient is a company resident in the other Contracting State which has a permanent establishment in the first Contracting State and the payments are attributable to the permanent establishment then the payments will be deductible although received by a non-resident enterprise. Residence and tax exemption are not identical criteria. Article 24(4) OECD MC is not violated.

2.2.1.2. Compatibility with the interest and royalty directive

The primary response does not conflict with the Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different

¹⁴ See also OECD BEPS Action 2 Deliverable Report, above fn.2, para 144 et seq.; concerning the question whether disallowing the deductibility of interest payments is in line with Art. 9 OECD MC see Beiser, *Ausgewogene Aufteilung der Ertragsteuerbefugnis und Abzug von Schuldzinsen und Lizenzgebühren*, SWI 2014, 261; Eigelshoven in: Vogel/Lehner, *Doppelbesteuerungsabkommen*, Commentary, 6. ed. 2015, Art. 9 m.no. 28b; Ditz in: Schönfeld/Ditz, *DBA*, Art. 9, m.no. 24.

¹⁵ See Bruns in: Schönfeld/Ditz, *DBA*, 2013, Art. 24, m.no. 142; Wassermeyer in: Wassermeyer, *Doppelbesteuerung*, Commentary, 129th ed. 2015, Art. 24 m.no. 73; Rust in: Vogel/Lehner, *Doppelbesteuerungsabkommen*, Commentary, 6th ed. 2015, Art. 24 m.no. 145.

Member States¹⁶ (the interest and royalty directive) either. The Court of Justice of the European Union (CJEU) held in its judgment in *Scheuten Solar* that Article 1(1) of the directive only prevents the source state from levying a tax at the level of the recipient of the payments. Denying the deductibility of the payments at the level of the payer does not violate the directive.¹⁷

2.2.1.3. Compatibility with the fundamental freedoms

Denying a deduction for interest payments made to a company resident in another Member State and allowing a deduction for comparable payments made to a domestic company might conflict with the fundamental freedoms of the TFEU.¹⁸ Comparable situations are treated in an unequal way.¹⁹ Sometimes these rules are drafted in a neutral way; according to the wording of the provisions, the deductibility of a payment does not depend on the residence of the recipient but on whether the payments are tax exempt at the level of the recipient. In theory, the provisions could apply in a purely domestic and in a cross-border context. Within the same Member State the distinction between equity and debt is always the same. Hybrid mismatches only arise in a cross-border situation. Despite the apparently neutral formulation a distinction on the basis of an exemption of the payment at the level of the recipient constitutes a hidden discrimination as it applies only to cross-border situations.²⁰

A different treatment of domestic and cross-border situations is only permissible if the different treatment can be justified by imperative requirements in the general interest.

¹⁶ Council Directive of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (OJ 2003 L 157, p. 0049).

¹⁷ EuGH 21 July 2011, *Scheuten Solar Technology GmbH v Finanzamt Gelsenkirchen-Süd*.(C-397/09) (*Scheuten Solar*), ECR 2011, I-6455, ECLI:EU:C:2011:499, para 28: “It follows that Article 1(1) of Directive 2003/49, read in the light of recitals 2 to 4 in the preamble to the directive, aims to avoid legal double taxation of cross-border payments of interest by prohibiting the taxation of interest in the source Member State to the detriment of the actual beneficial owner. That provision thus concerns solely the tax position of the interest creditor.”; see Goebel/Küntschner, *Gewerbsteuerliche Hinzurechnung von Zinsen auf dem europarechtlichen Prüfstand - Ein Beitrag anlässlich der Urteilsverkündung im Fall Scheuten Solar Technology*, IStR 2011, 630; Englisch, *Comment on the request of the Bundesfinanzhof for a preliminary ruling (Scheuten Solar)*, *Highlights & Insights* 2010, 28; Peyerl, *Das neue Abzugsverbot für Zins- und Lizenzzahlungen im Konzern*, ÖStZ 2014, 223 (224); a.A. dagegen Wimpissinger, *Ist die Nichtabzugsfähigkeit von Zinsen und Lizenzgebühren nach § 12 KStG unionsrechtswidrig?*, SWI 2014, 220.

¹⁸ In favour of the applying of the freedom to provide services to loan agreements see ECJ 9 July 1997, *Société Civile Immobilière Parodi v. Banque H. Albert de Bary et Cie* (C-222/95) (*Parodi*), ERC 1997, I-3899, ECLI:EU:C:1997:345 para 17; Müller-Graf in: Streinz, *EUV/AEUV*, 2. Aufl. 2012, Art. 56 AEUV m.no. 22; in favour of applying the free movement of capital to loan agreements see Sedlaczek/Züger in: Streinz, *EUV/AEUV*, 2. Aufl. 2012, Art. 63 AEUV m.no. 19. If a loan is granted between two members of the same group the freedom of establishment might apply.

¹⁹ The ECJ 12. July 2005, *Egon Schempp v Finanzamt München V*.(C-403/03) (*Schempp*), Slg. 2005, I-6421, ECLI:EU:C:2005:446 para 35, however, argues that alimony payments made to an Austrian resident are not comparable to alimony payments to a German resident.

²⁰ For the prohibition of hidden discriminations see already ECJ 12 February 1974, *Giovanni Maria Sotgiu v Deutsche Bundespost* (152/73) (*Sotgiu*), ECR 1974, 153, ECLI:EU:C:1974:13, para 11.

The fight against tax abuse constitutes a legitimate purpose which justifies a restriction of the fundamental freedoms.²¹ Disallowing a deduction of interest payments in all cases of hybrid mismatches to fight abuse is, however, not proportionate.²² The CJEU held in its *Cadbury Schweppes* judgment that domestic anti-avoidance rules must be restricted to fight wholly artificial arrangements.²³ In general, hybrid mismatch arrangements do not lack substance. Denying a deduction in all cases of hybrid mismatch arrangements – even if these arrangements are not wholly artificial – would, therefore, go beyond what is necessary to fight abuse. In its decision *RBS Deutschland* which concerned a VAT case the ECJ stated that tax arbitrage – using different VAT rules in two Member States – does not constitute tax abuse.²⁴ The case dealt with the following situation: A company resident in Germany provided leasing services in the UK. In the UK, these leasing arrangements were regarded as supply of services. From the perspective of the UK the place of supply of the services was the place where the supplier had established his business. As the supplier was a resident of Germany the supply of services was not taxable in the UK. From the perspective of Germany, however, the leasing arrangement was regarded as a supply of goods. The place of the supply of goods was in the UK as the goods were located in the UK. As a consequence, the leasing arrangement was not taxable in Germany either. Despite the double non-taxation, the German company asked for a refund of the input VAT. The company relied on Article 17(3) of the Sixth Council Directive.²⁵ According to this provision, the taxpayer is entitled to a deduction or a refund of his input VAT if the leasing arrangement would be eligible for deduction of tax had the place of supply of services been in the UK. This was the case, the German company would have been entitled to a deduction or a refund had the services been supplied in the UK. The CJEU stated that

“[i]n so far as differences in the laws and regulations of the Member States continue to exist in this area, despite the establishment of the common system of VAT by the provisions of the directive, the fact that a Member State has not collected output VAT because of the manner in which it has

²¹ See Cordewener, *Europäische Grundfreiheiten und nationales Steuerrecht*, 2002, p. 950 et seq.; L.de Broe, *International Tax Planning and Prevention of Abuse*, (IBFD, 2008), p. 799 et seq.

²² See Wimpissinger, *Ist die Nichtabzugsfähigkeit von Zinsen und Lizenzgebühren nach § 12 KStG unionsrechtswidrig?*, SWI 2014, 220.

²³ ECJ 12 September 2006, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v HMRC* (C-196/04) (*Cadbury Schweppes*), ECR 2006, I-7995, ECLI:EU:C:2006:544, para 55; see also ECJ 13 March 2007, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* (C-524/04) (*Test Claimants in the Thin Cap Group Litigation*), ECR 2007, I-2107, ECLI:EU:C:2007:161 para 72; ECJ 16 July 1998, *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)*. (C-264/96) (*ICI*), ECR 1998, I-4695, ECLI:EU:C:1998:370 para 26.

²⁴ ECJ 22 December 2010, *HMRC v RBS Deutschland Holdings GmbH* (C-277/09) (*RBS Deutschland Holding*), ECR 2010, I-13805, ECLI:EU:C:2010:810.

²⁵ Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment (OJ 1977 L 145, p. 0001; Art. 17(3)(a).

categorised a commercial transaction cannot deny a taxable person the right to deduct input VAT paid in another Member State.”²⁶

The UK Government argued that making use of the differences in tax law of two different countries should be characterised as abusive but the Court refuted that argument by stating that

“[i]n those circumstances, the fact that services were supplied to a company established in one Member State by a company established in another Member State, and that the terms of the transactions carried out were chosen on the basis of factors specific to the economic operators concerned, cannot be regarded as constituting an abuse of rights. RBS Deutschland in fact provided the services at issue in the course of a genuine economic activity.”²⁷ The Court goes on by saying: “It is important to add that taxable persons are generally free to choose the organisational structures and the form of transactions which they consider to be most appropriate for their economic activities and for the purposes of limiting their tax burdens.”²⁸

Transferring this decision from the field of VAT to direct taxation means that tax arbitrage transactions may not be regarded as abusive if the transactions do not lack substance. As a result, limiting the deductibility of interest payments made to foreign companies cannot be justified by the argument to fight abuse.

At most, the denial of a deduction for interest payments which are excessive and not in line with the arm’s length standard can be justified as an anti-abuse measure.²⁹

However, it seems to be possible that the non-deductibility of interest payments may be justified to achieve the coherence of the tax system if the payments are tax exempt at the level of the recipient. The different treatment at the level of the payor can be justified by the fact that the treatment at the level of the recipient is different as well: the payments are not deductible at the level of the payor if they are exempt at the level of the recipient and they are deductible at the level of the payor if they are taxable at the level of the recipient. The jurisprudence of the CJEU is ambiguous as to whether a Member State may adopt a linking rule and make the deductibility of payments dependent on the tax treatment in another Member State. There are good arguments that a principle of correspondence is in line with the fundamental freedoms.

²⁶ *RBS Deutschland Holding*, above fn.24, C-277/09, ECR 2010, I-13805, para 42.

²⁷ *RBS Deutschland Holding*, above fn.24, C-277/09, ECR 2010, I-13805, para 52.

²⁸ *RBS Deutschland Holding*, above fn.24, C-277/09, ECR 2010, I-13805, para 53.

²⁹ See ECJ 21 January 2010, *Société de Gestion Industrielle (SGI) v État belge*(C-311/08) (SGI), ECR 2010, I-487, ECLI:EU:C:2010:26, para 72; ECJ 5. July 2012, *Société d'investissement pour l'agriculture tropicale SA (SIAT) v État belge* (C-318/10) (SIAT), ECLI:EU:C:2012:415, para 52.

The CJEU confirmed in several judgments that the fundamental freedoms do not oblige a Member State to avoid juridical double taxation.³⁰ With regard to double taxation a Member State does not have to adapt its own tax system to the tax system of other Member States and take into account that the taxes due in other Member States reduce the ability to pay of the taxpayer. However, in other judgments the CJEU came to the opposite conclusion and decided that a Member State has to take the tax situation in the other Member State into consideration. For instance, the State of the parent company has to allow a deduction for losses incurred in a foreign subsidiary if the subsidiary can no longer use these losses in its residence state.³¹ The same interdependence between the laws of two Member States also applies with regard to losses of a foreign permanent establishment. EU law requires the State of the head office to allow a deduction for foreign losses incurred by the permanent establishment if it is no longer possible to use the losses in the permanent establishment state.³² The CJEU also held that the source state has to allow a deduction for certain personal expenses and grant the non-resident taxpayer access to the zero bracket if the residence state cannot take these deductions into account in case the taxpayer does not earn income in the residence state.³³ According to the jurisprudence of the CJEU, the Member State of the shareholder also has to grant an indirect credit for taxes paid in another Member State if it allows an indirect credit in a domestic setting.³⁴ In all these cases one Member State had to adapt its own law to the tax

³⁰ ECJ 14 November 2006, *Mark Kerckhaert, Bernadette Morres v Belgische Staat* (C-513/04) (Kerckhaert and Morres), ECR 2006, I-10967, ECLI:EU:C:2006:713; ECJ 16 July 2009, *Jacques Damseaux v Belgian State* (C-128/08) (Damseaux), ECR 2009, I-6823, ECLI:EU:C:2009:471; ECJ 12 February 2009, *Margarete Block v Finanzamt Kaufbeuren* (C-67/08) (Block), ECR 2009, I-883, ECLI:EU:C:2009:92; see also the seminal work by G. Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht*, (Linde Verlag, 2007) see also A.Rust (Hrsg.), *Double Taxation within the European Union*, (Wolters Kluwer, 2011).

³¹ From an EU perspective a cross-border loss compensation is only possible if the Member State of the parent allows a consolidation of profits and losses between parent and subsidiary in a domestic setting. See ECJ 13 December 2005, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* (C-446/03) (Marks & Spencer), ECR 2005, I-10837, ECLI:EU:C:2005:763; ECJ 18 July 2007, *Oy AA*, (C-231/05) (Oy AA), ECR 2007, I-6373, ECLI:EU:C:2007:439; see also, M. Lang, *The Marks and Spencer Case — The Open Issues Following the ECJ's Final Word*, *European Taxation*, 2006, 54; M.Lang, *European Union - Has the Case Law of the ECJ on Final Losses Reached the End of the Line?*, *European Taxation*, (Volume 54), No 12, 2014, 530; G. Kofler, *Marks & Spencer: Bedingte Verpflichtung zur Hereinnahme von Verlusten ausländischer Tochtergesellschaften*, *ÖStZ* 2006, 48.

³² ECJ 15 Mai 2008, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn* (C-414/06) (Lidl Belgium), ECR 2008, I-3601, ECLI:EU:C:2008:278; ECJ 23 October 2008, *Finanzamt für Körperschaften III in Berlin v Krankenhaus Ruhesitz am Wannsee-Seniorenheimstatt GmbH* (C-157/07) (Krankenhaus Ruhesitz am Wannsee-Seniorenheimstatt), ECR 2008, I-8061, ECLI:EU:C:2008:588; see also W. Haslehner, *Cross-Border Loss Relief for Permanent Establishments under EC Law*, *Bulletin for International Taxation*, (2010) 64 (1), 33.

³³ ECJ 14 February 1995, *Finanzamt Köln-Altstadt v Roland Schumacker* (C-279/93) (Schumacker), ECR 1995, I-225, ECLI:EU:C:1995:31; see also Cordewener, *Europäische Grundfreiheiten und nationales Steuerrecht*, 2002, p. 480 et seq.; Schnitger, *Die Rechtsprechung des EuGH zu Berücksichtigung persönlicher Verhältnisse, eine Sackgasse?*, *IStR* 2002, 478.

³⁴ ECJ 7 September 2004, *Petri Manninen. Reference for a preliminary ruling: Korkein hallinto-oikeus - Finland*.(C-319/02) (Manninen), ECR 2004, I-7477, ECLI:EU:C:2004:484; see also J. Englisch, *Fiscal Cohesion in the Taxation of Cross-Border Dividends (Part Two)*, *European Taxation*, 2004, 355; A. Rust, *Renaissance der Kohärenz*, *EWS* 2004, 450-454.

law of the other Member State and take the tax treatment in the other Member State into account for its own tax assessment.

In other judgments the CJEU did not go so far as to create an obligation to take the tax treatment in the other Member State into account but stated that a Member State is not prevented from taking the tax situation in the other Member State into consideration. For instance, a Member State may deny a tax benefit to avoid the taxpayer receiving the benefit twice. In the *de Groot* judgment, the CJEU held that the residence state of the taxpayer may restrict the deductibility of personal expenses to the extent that these expenses are already taken care of in the source state.³⁵ The CJEU came to a similar conclusion in the *N* judgment and stated that the former residence state is no longer obliged to take into account decreases in value of the shares after the emigration of the taxpayer if the new residence state allows a deduction for the decreases after immigration.³⁶ In addition, a Member State may – under certain conditions – still treat non-residents in a discriminatory way if the discrimination is neutralised by the residence state.³⁷ In this line of jurisprudence the non-residence state may adapt its tax law to the tax treatment in the other Member State.

The *Eurowings* and the *Schempp* judgments of the CJEU are especially relevant to the question whether the deductibility of interest payments at the level of the payor can be made dependent on the taxability of the payments at the level of the recipient.³⁸ However, both judgments come to

³⁵ ECJ 12 December 2002, *F.W.L. de Groot v Staatssecretaris van Financiën* (C-385/00) (*de Groot*), ECR 2002, I-11819, ECLI:EU:C:2002:750, par 99 et seq.; see also P. Wattel, *Progressive Taxation of Non-Residents and Intra-EC Allocation of Personal Tax Allowances*, *European Taxation* 2000, 210; Valat, *General Allowances and Home State Obligations under EC Law: Opinion Delivered in the de Groot Case*, *European Taxation* 2002, 446.

³⁶ ECJ 7 September 2006, *N v Inspecteur van de Belastingdienst Oost/kantoor Almelo*. (C-470/04) (*N*), ECR 2006, I-7409, ECLI:EU:C:2006:525, para 54. However, this jurisprudence seems to have changed in the meantime: According to ECJ 29 November 2011, *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam* (C-371/10) (*National Grid Indus*), ECR 2011, I-12273, ECLI:EU:C:2011:785, para 58 et seq., the former residence state is never obliged to take post emigration decreases in value of the shares into account.

³⁷ For the requirement that the credit obligation must be contained in a tax treaty and that the residence state is indeed capable of granting a credit for the discriminatory source tax see ECJ 14 December 2006, *Denkavit Internationaal BV and Denkavit France SARL v Ministre de l'Économie, des Finances et de l'Industrie* (C-170/05) (*Denkavit*), ECR 2006, I-11949, ECLI:EU:C:2006:783; ECJ 8 November 2007, *Amurta SGPS v Inspecteur van de Belastingdienst/Amsterdam* (C-379/05) (*Amurta*), ECR 2007, I-9569, ECLI:EU:C:2007:655; ECJ 11 September 2008, *D. M. M. A. Arens-Sikken v Staatssecretaris van Financiën* (C-43/07) (*Arens-Sikken*), ECR 2008, I-6887, ECLI:EU:C:2008:490; ECJ 19 November 2009, *Commission of the European Communities v Italian Republic*. (C-540/07) (*Commission v. Italy*), ECR 2009, I-10983, ECLI:EU:C:2009:717; for a differing view see EFTA Court 23 November 2004, *Fokus Bank ASA v. The Norwegian State* (E-1/04) (*Fokus Bank ASA*), EFTA Ct. Rep. 2004, 11; see also the seminal article by G. Kofler, *Tax Treaty "Neutralization" of Source State Discrimination under the EU Fundamental Freedoms?*, *BIT* 2011, 684.

³⁸ ECJ 26 October 1999, *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna* (C-294/97) (*Eurowings*), ECR 1999, I-7447, ECLI:EU:C:1999:524.; see for this judgment A. Cordewener, *Europäische Grundfreiheiten und nationales Steuerrecht*, 2002, p. 692 et seq.; ECJ 12 July 2005, *C-403/03* (*Schempp*), above fn.19, ECR 2005, I-6421, ECLI:EU:C:2005:446; see for this judgment M. Lang, *ECJ Decision in the Schempp Case: More Room for Member States*, *SWI* 2005, 411.

different conclusions. In its *Eurowings* decision the Court held that the deductibility of leasing payments for purposes of the German trade tax may not be denied just because the payments are not subject to trade tax at the level of the recipient. As the advantage (deductibility of the payments at the level of the payor) and the disadvantage (taxation of the payments at the level of the recipient) concerned two different taxpayers the Court decided that there is only an indirect link between advantage and disadvantage so that the different treatment cannot be justified by reason of the coherence of the tax system.³⁹ The Court also stated that the low taxation or non-taxation at the level of the recipient cannot justify the non-deductibility of the payments at the level of the payor. According to the Court

“any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State...[S]uch compensatory tax arrangements prejudice the very foundations of the single market.”⁴⁰

If one follows this line of reasoning the primary response suggested by the OECD would not be in line with the fundamental freedoms. The deductibility of the interest payments may not be refused with the argument that the payments benefit from a tax exemption at the level of the recipient. In the author’s opinion, however, the fight against hybrid mismatch arrangements goes well beyond compensatory measures in case of low- or no taxation. Low taxation or a tax exemption are generally the result of the deliberate decision of a country to grant a tax advantage. With regard to hybrid mismatch arrangements the taxpayer makes use of the differences in tax law between two countries. Both countries agree that the payments should be taxed either at the level of the payor or at the level of the recipient. Both countries only disagree on which level the tax should be levied. Denying the deductibility at the level of the payor achieves a one-time taxation which is the result desired by both countries. One could interpret the *Schempp*⁴¹ judgment in this way. Pursuant to this decision, it is not contrary to the fundamental freedoms to make the deductibility of alimony payments dependent on these payments being taxed at the level of the dependant. If one Member State generally exempts alimony payments from tax the other Member State may deny the deductibility of the payments at the level of the payor. The Court already excluded the comparability of payments to domestic dependants which were taxable with payments to foreign dependents which were not taxable by stating:

³⁹ ECJ 26 October 1999, C-294/97 (*Eurowings*), above fn.38, ECR 1999, I-7447, ECLI:EU:C:1999:524 para 41 et seq.

⁴⁰ ECJ 26 Oktober 1999, C-294/97 (*Eurowings*), above fn.38, ECR 1999, I-7447, ECLI:EU:C:1999:524, para 44 et seq.; this judgment is confirmed by ECJ 5 July 2012, C-318/10 (*SIAT*), ECLI:EU:C:2012:415, para 39.

⁴¹ *Schempp* (C-403/03), above fn.19, ECR 2005, I-6421, ECLI:EU:C:2005:446

“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. 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 12⁴² EC.”⁴³

The *Schempp* case also concerned differences which were attributable to two legal systems. While Germany allowed alimony payments – under certain conditions – to be deductible if they were taxable at the level of the dependant Austria disallowed a deduction at the level of the payor and exempted the payments at the level of the dependant. The Court regarded the denial of the deduction in Germany as appropriate to avoid a double non-taxation.

Overall, there are good reasons to argue that the primary response as proposed by the OECD does not conflict with the fundamental freedoms. The differences in treatment – allowing a deduction of interest payments if the payments are taxable at the level of the recipient and disallowing a deduction of interest payments if the payments are tax exempt at the level of the recipient seem to be justified by the need to fight against hybrid mismatch arrangements.

2.2.2. Defensive Rule

If the country in which the payor is a resident does not implement the proposal of the OECD and still allows a deduction for the interest payments then the obligation to avoid the mismatch switches to the residence state of the recipient of the payment. This state should no longer grant an exemption but include the payments in the tax base of the recipient. Germany has introduced such a linking rule in Sec. 8b(1) CITA.⁴⁴ In Austria a comparable linking rule can be found in Sec. 10(1) and (7) CITA.⁴⁵

2.2.2.1. Compatibility of the defensive rule with tax treaties

In general, taxing the payments at the level of the recipient in his residence state does not cause any conflict with tax treaties. For dividend and interest payments the credit method applies.⁴⁶ As a result, the treaty does not oblige the residence state to exempt the payments. However, some particular treaties contain an inter-company dividend exemption preventing the residence state from taxing

⁴² Now TFEU Art. 18.

⁴³ ECJ 12 July 2005, *Schempp* (C-403/03), above fn.19, ECR 2005, I-6421, ECLI:EU:C:2005:446, para 35 et seq.

⁴⁴ If exemption is denied foreign source taxes can be credited in accordance with Sec. 26(1) second sentence CITA. If the source taxes are high the credit may be even more beneficial as expenses linked to the foreign income are deductible. Sec. 8b(5) CITA does no longer apply.

⁴⁵ Sec. 10(1) and (7) Austrian CITA states that dividends are generally tax exempt. This tax exemption does not apply if the dividend payments are deductible at the level of the foreign corporation. For a good illustration of these rules see Kofler, „Hybride Finanzinstrumente“ in der Mutter-Tochter-RL, ZFR 2014, 214 (216 et seq.).

⁴⁶ See Art. 23A(2) und 23B(1) OECD MC.

dividend distributions.⁴⁷ For the question whether the defensive rule proposed by the OECD would conflict with inter-company dividend exemptions contained in tax treaties one has to distinguish two scenarios: If the characterisation as dividend for treaty purposes is derived from domestic law in accordance with Article 10(3) third option OECD MC a hybrid mismatch arrangement cannot arise. The residence state of the company making the payment characterises the payment as interest and this characterisation is binding for the residence state as well. If the characterisation as dividend is derived from the autonomous definition then the inter-company dividend exemption contained in the treaty prevents the residence state from taxing the payments although the payments are deductible at the level of the payor.

In its Model Treaty Germany has restricted the scope of the inter-company dividend exemption. An exemption for dividends is excluded if the payments are deductible at the level of the paying company.⁴⁸ As a result, the defensive rule will no longer conflict with future treaties concluded by Germany. Germany also introduced a treaty overriding provision in its domestic law. It will not apply the inter-company dividend exemption contained in its treaties if the payments are deductible at the level of the payor.⁴⁹ As a consequence, Germany will apply the defensive rule irrespective of its treaty obligations.⁵⁰

2.2.2.2. Compatibility with the parent-subsidiary directive

Article 4(1)(a) of the parent subsidiary directive in its version of November 30, 2011⁵¹ requires the Member State of the parent company to exempt the payments irrespective of whether or not the payments were deductible at the level of the subsidiary. The amendment of the parent-subsidiary

⁴⁷ See Ismer in: Vogel/Lehner, Doppelbesteuerungsabkommen, Kommentar, 6th ed. 2015, Art. 23 m.no. 78 et seq., 90 et seq.; Wassermeyer in: Wassermeyer, DBA, 129th ed. 2015, Art. 23 OECD MA m.no. 55.

⁴⁸ See Art. 10(1) N°1 sentence 3 of the German Model Treaty 2013 (Basis for negotiation for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital).

⁴⁹ Sec. 8b (1) sentence 1-3 CITA has the following wording: “Bezüge im Sinne des § 20 Abs. 1 Nr. 1, 2, 9 und 10 Buchstabe a des Einkommensteuergesetzes bleiben bei der Ermittlung des Einkommens außer Ansatz. Satz 1 gilt nur, soweit die Bezüge das Einkommen der leistenden Körperschaft nicht gemindert haben. Sind die Bezüge im Sinne des Satzes 1 nach einem Abkommen zur Vermeidung der Doppelbesteuerung von der Bemessungsgrundlage für die Körperschaftsteuer auszunehmen, gilt Satz 2 ungeachtet des Wortlauts des Abkommens für diese Freistellung entsprechend.“

⁵⁰ For the relationship between Sec. 8b (1) CITA and tax treaties see Rengers in: Blümich, Kommentar zum EStG, KStG und GewStG, 125. Aufl. 2015, § 8b KStG Rz. 140; see also Becker/Loose, Zur geplanten Ausdehnung des materiellen Korrespondenzprinzips auf hybride Finanzierungen, IStR 2012, 758 (762); for the question whether a treaty override is permissible in German law see Lehner in: Vogel/Lehner, Doppelbesteuerungsabkommen, Kommentar, 6th ed. 2015, Grundlagen m.no. 201; idem, Treaty Override im Anwendungsbereich des § 50d EStG, IStR 2012, 389; idem, Keine Verfügung des Parlaments über seine Normsetzungsautorität, IStR 2014, 189; Vogel, Keine Bindung an völkervertragswidrige Gesetze im offenen Verfassungsstaat. Europäisches Gemeinschaftsrecht in der Entwicklung, in: Blankenagel/Pernice/Schulze-Fielitz, FS Häberle, 2004, p. 481 et seq.; idem, Wortbruch im Verfassungsrecht, JZ 1997, 161 (162); Rust/Reimer, Treaty Override im deutschen Internationalen Steuerrecht, IStR 2005, 843.

⁵¹ Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

directive of July 8, 2014⁵² now also introduces a linking rule in Article 4(1)(a). According to the new version of Article 4(1)(a), the Member State of the parent (or of the permanent establishment) shall refrain from taxing the payments “to the extent that such [payments] are not deductible by the subsidiary, and tax such [payments] to the extent that such profits are deductible by the subsidiary”. Member States opting for the exemption method are, therefore, obliged to implement the defensive rule within the EU. For the time before the amendment of the directive entered into force, the defensive rule was not in line with the parent-subsidiary directive. Exemption had to be granted unconditionally. The Member State of the parent company was not allowed to make the exemption dependent on the payments not being deductible at the level of the subsidiary.⁵³ The amendment only has an ex-nunc effect and cannot heal the violations of the parent-subsidiary in the past.⁵⁴

The territorial scope of the directive is limited to the EU. The directive is silent on how to treat payments received from companies located outside the EU.⁵⁵

2.2.2.3. Compatibility with the fundamental freedoms

Depending on the amount of shareholding the distribution of dividends can be covered by the free movement of capital or by the freedom of establishment.⁵⁶ Although the linking rule is drafted in a neutral way – as it applies to both domestic and cross-border payments – in reality hybrid mismatch arrangements only arise in cross-border situations. The defensive rule can be regarded as a hidden discrimination.⁵⁷

⁵² Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

⁵³ See ECJ 12 February 2009, *Belgische Staat v Cobelfret NV* (C-138/07) (Cobelfret), ECR 2009, I-731, ECLI:EU:C:2009:82 para 33; ECJ 4 June 2009, *Belgische Staat v KBC Bank NV* (C-439/07) (KBC Bank), ECR 2009, I-4409, ECLI:EU:C:2009:339, para 36 et seq.

⁵⁴ Desens, *Ist die neue Korrespondenzregel in der Mutter-Tochter-Richtlinie mit dem primären Unionsrecht vereinbar?*, *IStR* 2014, 825 (826); idem, *Kritische Bestandsaufnahme zu den geplanten Änderungen in § 8b KStG*, *DStR Beih. zu Heft 4/2013*, 13 (19).

⁵⁵ Germany and Austria apply the linking rule also to payments received from companies outside the European Union.

⁵⁶ In favour of the application of the free movement of capital see ECJ 6 June 2000, *Staatssecretaris van Financiën v B.G.M. Verkooijen* (C-35/98) (Verkooijen), ECR 2000, I-4071, ECLI:EU:C:2000:294, para 28 et seq.; ECJ 15 July 2004, *Anneliese Lenz v Finanzlandesdirektion für Tirol* (C-315/02) (Lenz), ECR 2004, I-7063, ECLI:EU:C:2004:446; in favour of the application of the freedom of establishment see ECJ 23 February 2006, *Finanzamt Offenbach am Main-Land v Keller Holding GmbH* (C-471/04) (Keller Holding), ECR 2006, I-2107, ECLI:EU:C:2006:143; ECJ 26. June 2008, *Finanzamt Hamburg-Am Tierpark v Burda GmbH* (C-284/06) (Burda), ECR 2008, I-2009, 424, ECLI:EU:C:2008:365; see also Englisch, *Dividendenbesteuerung*, 2005, S. 215 ff.; Rust, *Anforderungen an eine EG-rechtskonforme Dividendenbesteuerung*, *DStR* 2009, 2568 (2569 et seq.). The German Bundesfinanzhof 29 August 2012, *IStR* 2012, 935 (937) held that only the freedom of establishment applies if the shareholder has an interest of at least 10% in the company.

⁵⁷ See already fn. 20; see also Thömmes/Linn, *The New German DCL and Dividend Matching Rules and EU Law*, *Intertax* 2014, 28 (33).

The different treatment of domestic and cross-border dividends is, however, justified.⁵⁸ In a domestic situation the subsidiary distributing the dividends has already been taxed. In a cross-border situation the payments were deductible at the level of the subsidiary so that the dividends do not carry an underlying corporate tax. The tax exemption of dividends has the goal of avoiding economic double taxation. If the payments are deductible an economic double taxation does not occur. A tax exemption is not necessary to avoid economic double taxation if the payments are deductible at the level of the subsidiary.

The CJEU has confirmed on several occasions the equal value of the exemption method and the indirect credit method. It held that

“European Union law does not prohibit a Member State from preventing the imposition of a series of charges to tax on dividends received by a resident company by applying rules which exempt those dividends from tax when they are paid by a resident company, while preventing those dividends from being liable to a series of charges to tax through an imputation method when they are paid by a non-resident company...”⁵⁹

According to the CJEU,

“the imputation method enables dividends from non-resident companies to be accorded treatment equivalent to that accorded, by the exemption method, to dividends paid by resident companies. Application of the imputation method to dividends from non-resident companies makes it possible to ensure that foreign-sourced and nationally-sourced portfolio dividends bear the same tax burden...”⁶⁰

Denying the exemption in case of deductibility also ensures that domestic investments and cross-border investments bear the same overall tax burden. Denying the exemption and taxing the

⁵⁸ One could, however, argue that neither the domestic linking rules based on the OECD proposal nor the new version of the parent-subsidiary directive achieve the goal of double non-taxation as they are incomplete. They only cover situations of double non-taxation caused by the deductibility of the payments at the level of the payor. If the subsidiary state reduces its corporate tax rate in case of a distribution to zero per cent and the parent state exempts the dividends double non-taxation can also arise. This situation is not covered by the OECD proposal and the new version of the parent-subsidiary directive. O. Thömmes/Linn, 'The New German DCL and Dividend Matching Rules and EU Law' (2014) 42 *Intertax*, Issue 1, pp. 28 argue that the defensive rule does not comply with the freedom of establishment.

⁵⁹ ECJ 10 February 2011, *Haribo Lakritzen Hans Riegel BetriebsgmbH (C-436/08) and Österreichische Salinen AG (C-437/08) v Finanzamt Linz*. (Haribo/Salinen), ECR 2011, I-305, ECLI:EU:C:2011:61 para 86; see also ECJ 12 December 2006, *Test Claimants in the FII Group Litigation v HMRC (C-446/04)* (Test Claimants in the FII Group Litigation), ECR 2006, I-11753, ECLI:EU:C:2006:774, paras 48 and 57; ECJ 23 April 2008, *The Test Claimants in the CFC and Dividend Group Litigation v HMRC (C-201/05)* (Test Claimants in the CFC and Dividend Group Litigation), ECR 2008, I-2875, ECLI:EU:C:2008:239, para 39; Kofler/Prechtl-Aigner, *Die Beteiligungsertragsbefreiung nach Haribo und Salinen*, GES 2011, 175.

⁶⁰ ECJ 10 February 2011, *Haribo/Salinen C-436/08 and C-437/08*, above fn.59, ECR 2011, I-305, ECLI:EU:C:2011:61 para 89.

dividends leads to the same result as applying the indirect credit method. In case of the application of the indirect credit method the foreign dividends are taxed in the state of the parent company but the taxes paid by the subsidiary can be deducted from the tax liability in the state of the parent company. If the payments are deductible at the level of the subsidiary there are no taxes of the subsidiary to be credited so that the application of the indirect credit method leads to a full taxation of the dividends.

3. Double Deductions

3.1. Tax planning opportunities

The BEPS Action 2: 2014 Deliverable Report⁶¹ also targets tax planning arrangements where interest payments are deductible in two countries. Such double deduction can be achieved through the creation of a dual resident company. Many countries define the criterion for residence in a different way. For example, in Germany a company having its place of management or its registered seat within Germany is subject to unlimited tax liability.⁶² In the US a company is subject to unlimited tax liability if it is created in accordance with the laws of the US or of one of its states.⁶³ If a company is organised under the laws of the US and managed in Germany it is subject to unlimited tax liability in both states. If this dual resident company takes a loan and pays interest on the loan the interest payments are deductible in the US and in Germany. Losses of the dual resident company can be transferred to companies in the US and in Germany through the use of group regimes.⁶⁴

The BEPS Report proposes to limit the deductibility of interest payment in this constellation.⁶⁵ Interest payments should only be deductible up to the amount of positive income received by the company. Interest which exceeds the amount of positive income can be carried forward. A country should only allow a deduction for interest payments if the taxpayer proves that he cannot deduct the payments in the other state.

A double deduction can also be obtained if the taxpayer invests through a permanent establishment in another state. If a company sets up a permanent establishment in another country and this permanent establishment suffers a loss the company can deduct the permanent establishment losses

⁶¹ OECD BEPS Action 2 Deliverable Report, above fn.2.

⁶² See Sec. 10 and 11 General Tax Code.

⁶³ See Sec. 7701(a)(4) Internal Revenue Code: The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State...

⁶⁴ See for Germany Sec. 14 CITA (Organschaft); for the US see Sec. 1501 IRC. Both countries, however, restrict the double use of losses in their domestic tax law. See the dual consolidated loss rules in Sec. 14 (1) first sentence N° 5 CITA (Germany) und Sec. 1503(d) IRC (US).

⁶⁵ OECD, BEPS Action 2: 2014 Deliverable Report, above fn.2. para 103 et seq.

from its profits earned by the head office due to the system of world-wide taxation.⁶⁶ By transferring the loss of the permanent establishment to another group member in the same country the loss can be deducted for a second time in the permanent establishment state.⁶⁷

To solve the double use of losses the BEPS Report proposes a solution consisting of two steps.⁶⁸ According to the primary response, the interest payments should be deductible in the permanent establishment state only. The residence state of the company should deny the deduction for interest payments borne by the permanent establishment unless it has already taxed positive income of the permanent establishment. If the head office state nevertheless allows a deduction for the interest payments attributable to the permanent establishment then the defensive rule applies: to the extent that the interest payments are deductible in the residence state the permanent establishment state has to deny a deduction. Non-deductible expenses can be carried forward.

In Germany, a legislative draft was discussed in parliament in which interest expenses would no longer be deductible if another country allows a deduction for the interest payments.⁶⁹ However, this proposal was abandoned in parliament and never entered into force. Concerning the double use of losses in group regimes, Germany has already introduced Sec. 14 (1) first sentence N°5 CITA which prevents “double dips”.⁷⁰

3.2. Compatibility of the OECD Proposals with the fundamental freedoms

Denying the deduction of interest expenses in case such expenses are deductible in another country as well constitutes a restriction of the freedom of establishment. In a purely domestic situation such

⁶⁶ The deduction of foreign permanent establishment losses may be excluded by a tax treaty or by a domestic foreign loss limitation rule. According to the German Bundesfinanzhof foreign permanent establishment losses are no longer deductible if the tax treaties contains the exemption method in accordance with Art. 23A(1) OECD MC. Pursuant to the Bundesfinanzhof both positive and negative income can no longer be taken into account for calculating the tax base. See Bundesfinanzhof 6 October 1993, I R 32/93, BStBl. II 1994, 113; Bundesfinanzhof 17 July 2008, I R 84/04, BStBl. II 2009, 630; see also Ismer in: Vogel/Lehner, Doppelbesteuerungsabkommen, Kommentar, 6. Aufl. 2015, Art. 23 m.no. 52 ff. A domestic loss limitation rule can be found in Germany in Sec 2a (1) first sentence N° 2 ITA.

⁶⁷ In Germany permanent establishments can form part of a group consolidation regime, see Sec. 14 (1) first sentence N° 2 CITA.

⁶⁸ OECD, BEPS Action 2: 2014 Deliverable Report, above fn.2. para 97 et seq.

⁶⁹ See the legislative proposal for the introduction of Sec. 4(5a) sentence 2 and 3 ITA of 24 October 2014, BR-Drs. 432/1/14 p. 12. The proposal had the following wording: “Die einer Betriebsausgabe zugrunde liegenden Aufwendungen sind nur abziehbar, soweit die nämlichen Aufwendungen nicht in einem anderen Staat die Steuerbemessungsgrundlage mindern. Satz 2 gilt nicht, wenn die Berücksichtigung der Aufwendungen ausschließliche dazu dient, einen Progressionsvorhalt i.S.d. § 32b Abs. 1 S. 1 Nr. 3 oder eine Steueranrechnung i.S.d. § 34c oder i.S.d. § 26 Abs. 1 des Körperschaftsteuergesetzes zu berücksichtigen.” See Kahlenberg, Neue Beschränkungen des Zinsabzugs: Regelungsempfehlungen gegen doppelte Nichtbesteuerungs- und Double-Dip-Strukturen, ISR 2014, 91; Linn, Zum Entwurf einer Betriebsausgabenabzugsbeschränkung im Zollkodex-Anpassungsgesetz, IStR 2014, 920.

⁷⁰ See *Scheipers/Linn*, Zur Unionswidrigkeit des § 14 Abs. 1 Nr. 5 KStG n. F., IStR 2013, 139; *Benecke/Schnitger*, Wichtige Änderungen bei der körperschaftsteuerlichen Organshaft durch das UntStG 2013, IStR 2013, 143.

expenses would have been clearly deductible. The avoidance of the double use of losses can, however, be regarded as an imperative requirement in the general interest capable of restricting the fundamental freedoms. The CJEU introduced this ground of justification in its *Marks & Spencer* judgment and has since used it in several other judgments.⁷¹ During recent years this jurisprudence has been refined in the following way: a Member State may deny the deductibility of losses incurred in a foreign permanent establishment if the permanent establishment state takes these losses into account as well.⁷² By contrast, if the losses are incurred within its territory a Member State may not deny the deduction of these losses even if another state allows a deduction as well. The CJEU stated in the *Philips Electronics* judgment that

“the host Member State, on whose territory the economic activity giving rise to the losses of the permanent establishment is carried out, cannot, in a situation such as that at issue in the main proceedings, use the objective of preserving the allocation of the power to impose taxes between the Member States as justification for the fact that, under its national legislation, the possibility of transferring, by means of group relief and to a resident company, losses sustained by the permanent establishment in that Member State of a non-resident company is subject to a condition that those losses cannot be used for the purposes of foreign taxation...”⁷³

The CJEU held that under the arguments the prevention of the double use of losses cannot be invoked as justification either:

“As regards, secondly, the objective of preventing the double use of losses, it must be observed that even if such a ground, considered independently, could be relied on, it cannot in any event be relied

⁷¹ ECJ. 13 December 2005, *Marks & Spencer*, C-446/03 above fn.31, ECR 2005, I-10837, ECLI:EU:C:2005:763, para 47: “As regards the second justification, relating to the danger that losses would be used twice, it must be accepted that Member States must be able to prevent that from occurring.” see also ECJ 29 March 2007, *Rewe Zentralfinanz eG v Finanzamt Köln-Mitte* (C-347/04) (*Rewe Zentralfinanz*), ECR 2007, I-2647, ECLI:EU:C:2007:194, para 47; ECJ 15 May 2008, *Lidl Belgium* (C-414/06), above fn.32, ECR 2008, I-3601, ECLI:EU:C:2008:278 para 35. Kahlenberg, *Neue Beschränkungen des Zinsabzugs: Regelungsempfehlungen gegen doppelte Nichtbesteuerungs- und Double-Dip-Strukturen*, ISR 2015, 91 (96) argues that the double use of losses constitutes the other side of the coin which is double taxation. If two countries tax the positive income of the same taxpayer both countries have to allow a deduction for negative income as well.

⁷² See ECJ 6 September 2012, *HMRC v Philips Electronics UK Ltd* (C-18/11) (*Philips Electronics*), ECLI:EU:C:2012:532, para 26; see also the opinion of Advocate General Kokott of 19 April 2012, C-18/11 (*Philips Electronics*), ECLI:EU:C:2012:532, para 51; see also B.Terra, P.Wattel, *European Tax Law*, 6th ed. (Wolters Kluwer, 2012), p. 938.

⁷³ See ECJ 6 September 2012, *Philips Electronics* (C-18/11), above fn.72, ECLI:EU:C:2012:532, para 27. The CJEU focused on the different treatment of domestic companies and permanent establishments. While domestic company could deduct losses even if these losses were deductible in other Member State as well permanent establishments of foreign companies were not allowed to deduct losses if these losses were deductible in other countries. See also Schiefer, *Anmerkung*, IStR 2012, 849.

on in circumstances such as those in the main proceedings to justify the national legislation of the host Member State.”⁷⁴

Advocate General Kokott had already argued in her opinion in *re Philips Electronics* that the balanced allocation of taxing powers of the permanent establishment state is not restricted in any way by the fact that another country takes into account the losses as well.⁷⁵ The permanent establishment state is not permitted to deny a deduction of losses which have been incurred within its territory just because another Member States allows a deduction of these losses as well.

As a consequence, the defensive rule obliging the permanent establishment state to disallow losses incurred within its territory to avoid the double use of losses does not comply with the freedom of establishment.

4. Conclusions

The OECD Report “Neutralising the Effects of Hybrid Mismatch Arrangements Action 2: 2014 Deliverable” of 16 September 2014⁷⁶ makes several proposals to avoid double non-taxation caused by tax arbitrage. The proposals – if implemented – will achieve their goal. They are capable of limiting the use of hybrid instruments and of structures to generate double deductions. In the author’s opinion, the proposals are not very balanced. They only target the problem of double non-taxation and do not deal with the problem of remaining double taxation.⁷⁷ The proposals require an effective exchange of information. Linking its own tax law to the laws of another state is only possible if the provisions in the other state are known and understood. The BEPS proposals can be regarded as generally compliant with the non-discrimination provisions contained in tax treaties and in the TFEU. However, the OECD proposal to fight against double deduction schemes with regard to foreign permanent establishments – the defensive rule – is not in line with the fundamental freedoms. The permanent establishment state may not justify the denial of a deduction for interest expenses with the argument that the expenses are already deductible in the head office state. As the expenses are borne by the permanent establishment, the permanent establishment state is prohibited from denying the deductibility of the expense in a discriminatory way.

⁷⁴ ECJ 6 September 2012, *Philips Electronics* (C-18/11), above fn.72, ECLI:EU:C:2012:532, para 28.

⁷⁵ Opinion of Advocate General Kokott of 19 April 2012, *Philips Electronics* (C-18/11), above fn.72, ECLI:EU:C:2012:532, para 50; see also Thömmes and Linn, above fn. 58, (2014) 42 Intertax, Issue 1, pp. 28 (30).

⁷⁶ BEPS Action 2 Deliverable Report, above fn.2.

⁷⁷ Van den Hurk, Proposed Amended Parent-Subsidiary Directive Reveals the European Commission’s Lack of Vision, BIT 2014, 488 (490) describes the EU measures as one-sided. See also L.Richter and D.Reeb, Zur Ausdehnung des materiellen Korrespondenzprinzips in § 8b Abs 1 S. 2 KStG durch das AmtshilfeRLUMsG im Spannungsfeld von Europa- und Völkerrecht, IStR 2015, 40 (52).