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Editorial

At Last, Some Output on the Fight against Double Non-taxation

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1 Why did it take so long?

In the aftermath of the crisis and the resulting budgetary impact, a global fight against so-called aggressive tax planning has emerged. The overarching theme of these actions seems to be a desire to tackle double non-taxation, which is perceived as undesirable from a policy perspective, as it (arguably) affects tax revenues, distorts competition, causes economic efficiency and hampers transparency and fairness.

One of the double non-taxation structures causing great concern are hybrid financial instruments. These are financial instruments for which at least two jurisdictions take mutually incompatible positions regarding the qualification of this instrument, so that a deductible payment of the payer is not treated as taxable income of the payee (deduction/non-inclusion). Not surprisingly, the OECD and European Commission have (both) taken initiatives to counter such hybrid financial instruments. The fact that such structures can also give rise to double taxation is largely ignored in these initiatives.

It is striking that, given the apparent need to counter double non-taxation caused by *inter alia* hybrid financial instruments, it has taken such a long time before any actual measures have emerged. On an EU level, the EU Code of Conduct Group already agreed in 2010 that '*in as far as payments under a hybrid [financial instrument] are qualified as a tax deductible expense for the debtor in the arrangement, Member States shall not exempt such payments as profit distributions under a participation exemption*' (doc. 10033/10, FISC 47, §31). Nonetheless, it took the Commission respectively until December 2012 and November 2013 to announce a revision of Article 4(1)(a) of the Parent-Subsidiary Directive in its action plan on tax fraud and evasion (COM(2012) 722 final) and issue an amending proposal for directive containing an 'anti-hybrid rule' that would (arguably) oblige the Member State of the parent company to tax the income received to the extent it had been deducted by the subsidiary (COM(2013) 814 final).

At first sight, this anti-hybrid rule received wide support from the Member States. However, when push came to shove, Sweden and Malta blocked a smooth adoption of the amending proposal, seemingly clinging on to their sovereignty in tax matters and national policy issues. Sweden submitted that the anti-hybrid rule would negatively affect an investment model used by large Swedish businesses (i.e., Volvo and Eriksson) by increasing the risk for double taxation. Malta, on the other hand, argued that compelling Member States to levy taxes on the basis of the revised Parent-Subsidiary Directive would infringe their sovereignty in taxation and would set a dangerous precedent for future legislation.

Sweden lifted its reservations after being given reassurances that the Swedish investment model would not fall within the scope of the (revised) directive, and by expressly confirming (in the Council minutes) that the anti-hybrid rule would not be applicable if there is no double non-taxation or if its application would lead to double taxation. Malta's objections were, however, of a more fundamental nature and could at first sight not easily be accommodated. As tax directives (amendments) require unanimity in the Council, the introduction of the anti-hybrid rule appeared rather unlikely. Nevertheless, Finance Ministers were able to reach unanimity in the 20 June 2014 Ecofin meeting, presumably placating Malta by including an express statement in the Council minutes that '*direct taxation [still] falls within the competence of Member States*'. After a journey of blood, sweat and tears, the fight against hybrid financial instruments has finally led to an actual output on an EU level.

2 What does the rule achieve (and what not)?

The new Article 4(1)(a) of the Parent-Subsidiary Directive, which will need to be transposed into domestic law before 31 December 2015, will (presumably, after final adoption) read as follows: '*Where a parent company [. . .], by virtue of the association of the*

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parent company with its subsidiary, receives distributed profits, the State of the parent company [. . .] shall [. . .] refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary' (underline LDB). The text agreed upon by the Ecofin thus deviates from the original Commission proposal, which did not include the underlined section. The obligation to tax being clearly reflected in the text of the directive is a positive development, as it puts an end to scholarly debates as to whether the (literal wording of the) original proposal actually included an obligation or a mere possibility to tax.

Nonetheless, the new anti-hybrid rule embedded in Article 4(1)(a) of the Parent-Subsidiary Directive might not live up to expectations. The obligation to tax is obviously only applicable within its material and territorial scope, i.e., distributed profits received by an EU parent company from its EU subsidiary by virtue of their association. Recalcitrant companies could for instance structure their hybrid financial instruments between an EU and a non-EU company. Prima facie, insubordinate Member States could uphold (tax) competitive environments by enacting exemptions for hybrid financial instruments that are paid, e.g., to a company not holding 10% of the shares of the payee (including a sister company) or for payments not qualifying as 'profits distributed by virtue of the association'.

Additionally, although Sweden yielded rather quickly, its argument that the anti-hybrid rule might trigger double taxation is still valid (and likely not mitigated by including a mere reference in the Council's minutes). Some EU Member States (e.g., France) have already enacted anti-hybrid rules that result in disallowing the tax deductibility of a payment by a (French) payer if the foreign payee is not sufficiently taxed on that income (e.g., because the payee can in principle invoke Article 4(1)(a) of the Parent-Subsidiary Directive). Absent any 'tie-breaker' rule in the Parent-Subsidiary Directive, a circular situation arises which may plausibly trigger double non-taxation. It would be wise to give some further thought to the anti-hybrid rule so as to avoid such pervasive effect.

3 EU and OECD two-track approach: converging or diverging?

Seemingly separate from the European Commission, the OECD started its own fight against hybrid financial instruments in 2012 with its report on Hybrid Mismatch Arrangements. It was continued in its BEPS action plan of 2013 (action 2) in the context of which the OECD will '*develop [. . .] recommendations regarding the design of domestic rules to neutralise the effect (e.g., double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities*'. It follows from one of its discussion drafts on action 2 (hybrids) that the OECD has decided to tackle double non-taxation caused by hybrid financial instruments by introducing a set of detailed 'linking rules'. Two main options are possible in this respect, i.e., *(i)* a rule denying the deduction for the payer if the payee is not taxed on the payment or *(ii)* a rule forcing income inclusion in the hands of the payee if the payer has obtained a tax deduction for the payment.

It is clear that Article 4(1)(a) of the revised Parent-Subsidiary Directive falls in the latter category. Does this correspond to what the OECD is suggesting? The OECD's approach consists of a 'primary rule' and a 'secondary rule'. The primary rule, which is the OECD's preferred approach, is to deny the deduction for the payer. The secondary rule, which enters into force if the relevant country has not enacted the primary rule, is to require inclusion of the income in the hands of the payee. At first sight, the OECD's approach is therefore not in line with (revised) Article 4(1)(a) of the Parent-Subsidiary Directive. However, presumably because of these EU law considerations, the OECD has foreseen an exception: if a 'dividend exemption' in the hands of the payee is to blame for the double non-taxation effect, this dividend exemption should not be granted. Due to this exceptional rule, the OECD's approach is *in extremis* brought in line with the EU approach.

There are still differences between the EU's and the OECD's approach, however. *First*, the OECD's approach is broader as it also covers hybrid mismatches other than hybrid financial instruments (although a Subgroup of the EU Code of Conduct Group is also working on hybrid entities and hybrid PEs, see doc. 11227/14, FISC 102). But the OECD's hybrid financial instruments rules also have a broader scope, as they also tackle instruments where the mismatch is not necessarily attributable to a dividend exemption (e.g., convertibles or interest free loans). *Second*, the OECD's recommendations are only 'soft law', whereas the EU has taken the 'hard law' approach by incorporating the anti-hybrid rule into a directive which Member States are legally obliged to transpose into domestic law. The OECD, however, will need to persuade individual countries' legislators to actually implement the OECD proposals into domestic law. *Third* and most importantly, the OECD has yet to deliver any actual measures.

4 Linking rules: the right approach?

Historically, leaving aside harmonization of tax legislation, two approaches have been suggested to counter double non-taxation caused by *inter alia* hybrid financial instrument, i.e., *(i)* applying general or specific anti-avoidance rules or *(ii)* domestic linking rules (irrespective of any anti-avoidance element). It follows clearly from the above that the OECD as well as the EU have opted for the second route, while initially the

OECD's 2012 Hybrid Mismatch Arrangements report (also) seemed to opt for the first route. This is laudable, as a hybrid financial instrument leading to double non-taxation does not in itself amount to 'abuse', as a result of which the first approach would often not be feasible.

However, the Commission's recommendation on aggressive tax planning (C(2012)8806) still seems to leave the door open for the second approach. It does so by first defining 'aggressive tax planning' as '*taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability*' (underline LDB) and, subsequently, by proposing a common general anti-abuse rule ('GAAR') that should counter such types of aggressive tax planning. It is submitted that the definition of 'aggressive tax planning' is too broad and fails to recognize that, within the EU, in the absence of a wholly artificial arrangement, Member States must recognize each others' tax systems, regardless of how different they might be. In other words, the set-up of a hybrid financial instrument does not in itself qualify as an abusive practice.[1] It should therefore be clarified that such a common GAAR should not be used to tackle hybrid mismatch arrangements.

1 L. De Broe, 'Some observations on the 2007 communication from the Commission: "The application of anti-abuse measures in the area of direct taxation within the EU and in relation to third countries"', *EC Tax Review* 2008, nr. 3, 146.