

Enforceability of OECD Linking Rules in the Light of EU Law

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ABSTRACT

To counter tax arbitrage resulting from the use of hybrid financial instruments, the Organization for Economic Co-operation and Development (OECD) suggested the implementation of anti-hybrid mismatch rules, which align the domestic tax treatment of hybrid financial instruments with their tax treatment in foreign countries. This paper assesses the enforceability of these so-called “linking rules” in the light of European Union (EU) law. Since the European Court of Justice (ECJ) has yet to rule on their relation to EU law, considerable weight is assigned to legal literature and comparable ECJ case law. Following the various steps of the analytical framework adopted by the ECJ, the author concludes that OECD linking rules are enforceable in the light of EU law, provided that the Member States implementing these rules domestically complement them with additional conditions.

INTRODUCTION

Background

Benjamin Franklin once famously said: “In this world nothing can be said to be certain, except death and taxes”.¹ Nevertheless, in today’s globalized world, these words seem to be rather meaningless. Multinational corporations such as

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¹ Benjamin Franklin, *The Private Correspondence of Benjamin Franklin* (2nd edn, H Colburn 1817) 266.

Google,² Amazon,³ and Starbucks⁴ avoid paying taxes by constituting all kinds of international tax planning schemes.⁵ According to Van Rompuy, former European Council President, an estimate of €1 trillion revenue is annually lost in the EU due to tax avoidance practices.⁶ Recent policy papers have indicated that a considerable amount of this figure could result from cross-border tax arbitrage.⁷ This avoidance technique can be defined as “the act of taking advantage of the inconsistencies of more than one country’s tax rules to realize a more favourable result than that provided for by a transaction in a single jurisdiction”.⁸ Hybrid financial instruments are commonly used to achieve this outcome.⁹ They can be described as financial instruments that “combine typical characteristics of equity and borrowed capital, thereby being economically positioned between these two forms of capital”.¹⁰ Depending on their qualification as either equity or debt, the tax treatment of such instruments may differ. Indeed, dividends as compensation for equity are usually not deductible by the payer, while the recipients are typically entitled to an exemption. Interests as compensation for debt, on the other hand, are deductible by the payer, but are taxed in the hands of the recipient.

Due to the current lack of harmonization in tax classification among jurisdictions, the use of hybrid financial instruments in cross border-transactions

² Peter Campbell, ‘Fresh Questions to be raised over Google’s Tax Avoidance as Tech Gains Announces Profits of \$3.4 Billion’ (*Daily Mail*, 31 January 2014) <<http://www.dailymail.co.uk/news/article-2549379/Fresh-questions-raised-Google-tax-avoidance-tech-giant-announces-profits-3-4-billion.html>> accessed 10 July 2016.

³ Ian Griffiths and Simon Bowers, ‘Fresh Questions for Amazon over Pittance It Pays in Tax’ (*The Guardian*, 16 May 2013) <<http://www.theguardian.com/technology/2013/may/15/amazon-tax-bill-new-questions>> accessed 10 July 2016.

⁴ ‘Starbucks Pays UK Corporate Tax for the First Time since 2009’ (*BBC*, 23 June 2013) <<http://www.bbc.com/news/uk-politics-23019514>> accessed 10 July 2016.

⁵ Hans van den Hurk, ‘Starbucks versus the People’ (2014) 68(1) BFIT 27, 27.

⁶ Georgi Gotev, ‘EU Summit to Grapple with Tax Havens, Evasion and Fraud’ (*EnrActiv*, 10 May 2013) <<http://www.euractiv.com/euro-finance/eu-leaders-prepare-tackle-tax-ha-news-519618>> accessed 10 July 2016.

⁷ OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (Paris, OECD Publishing 2012) 5.

⁸ Rafael Bispo, ‘Cross-Border Intra-Group Hybrid Finance: A Comparative Analysis of the Legal Approach Adopted by Brazil, the United Kingdom and the United States’ (2013) 67(7) BFIT 365, 367.

⁹ Other techniques include hybrid entities and hybrid transfers.

¹⁰ Christian Kahlenberg, ‘The Tax Treatment of Hybrid Financial Instruments’ (2015) 55(6) European Taxation 264, 264.

may give rise to double tax benefits (“double dip”).¹¹ This occurs when compensations for hybrid instruments are deductible in the country of the payer without being taxed in the country of the recipient.¹² These so-called “mismatch arrangements” negatively affect “tax revenue, competition, economic efficiency, transparency and fairness”.¹³ Therefore, in its latest report named “Neutralising the Effects of Hybrid Mismatch Arrangements”, the OECD suggested that Member States implement rules linking the domestic tax classification of hybrid financial instruments to their tax classification in foreign countries.¹⁴

Under these “OECD linking rules”, one State could successfully eliminate potential mismatches by allowing the deduction of interest payments to foreign entities on the condition that the other State does not provide dividend exemptions. Analogously, the former State could condition dividend exemptions on the refusal of interest deductions by the latter State.¹⁵ However, since potential mismatches can only arise in cross-border situations, linking rules promote a tax treatment of cross-border cases that is heavier than the taxation of similar domestic situations. Indeed, regarding domestic transactions, dividends are exempt and interests are deductible. Meanwhile, depending on the tax outcome in the foreign jurisdiction, the application of linking rules could result in the denial of these tax benefits in a cross-border context.

Purpose and approach

According to the case law of the European Court of Justice (ECJ), supranational EU law prevails over domestic law. Hence, for tax rules to be enforceable domestically, Member States need to respect EU law. Against this background, however, one could question the enforceability of linking rules. Indeed, according to the fundamental freedoms of the EU incorporated in the Treaty on the Functioning of the European Union (TFEU),¹⁶ payments made to non-residents must receive the same tax treatment as payments made to residents, unless a different treatment can be justified on grounds of an overriding public

¹¹ Niels Johannesen, ‘Tax avoidance with cross-border hybrid instruments’ (2014) 112 *Journal of Public Economics* 40, 40.

¹² *ibid.*

¹³ OECD (n 7) 11.

¹⁴ OECD, *Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements* (Paris, OECD Publishing 2015) 27.

¹⁵ *ibid.*

¹⁶ Consolidated Version of the Treaty on the Functioning of the European Union [2010] OJ C83/47 (TFEU). See text to n 60 below.

interest. Following the analytical framework of the ECJ, this paper will analyse these concepts and determine whether the more onerous tax treatment of non-residents, resulting from the application of linking rules, violates the EU fundamental freedoms. It will also tackle the extent to which such potential violation could be justified.

The aim of this paper is to answer the following research question: “Are the OECD linking rules proposed in Action 2 to address tax arbitrage enforceable in the light of EU law?”. However, before doing so, this paper examines the following preliminary issues:

- (1) What are hybrid financial instruments? (2) How are these instruments treated in the Netherlands and the United States (US)?
- What initiatives did the OECD undertake to tackle tax arbitrage?
- Do linking rules discriminate against non-residents who are in a similar situation as residents?
- Can a potential discrimination be justified on grounds of public interest, while, likewise, passing the proportionality test?

Methodology

This paper applies a combination of different research methods.¹⁷ Firstly, a comparative legal method is used to determine the risk of hybrid mismatches between the Netherlands and the US. Hence, the tax treatment practices of hybrid financial instruments in both countries are compared to each other.¹⁸ In this regard, the *PepsiCo* case will be used as a case study.

Furthermore, a traditional legal method is applied in analysing the relevant materials regarding OECD linking rules. Thus, different sources of law are evaluated throughout this paper including domestic legislation, OECD recommendations, as well as sources of both primary and secondary EU law. Moreover, since no judgment of the ECJ exists regarding the relationship between OECD linking rules and EU fundamental freedoms, this study assigns considerable weight to legal literature and comparable case law of the ECJ, together with the relevant opinions of the Advocate-Generals (AG).

¹⁷ Qunfang Jiang and Yifan Yuan, ‘Legal Research in International and EU Tax Law’ (2014) 54(10) *European Taxation* 470, 470.

¹⁸ Konrad Zweigert and Hein Kötz, *An Introduction to Comparative Law* (3rd edn, OUP 1998) 2.

Delimitation

In addition to hybrid financial instruments, mismatches can emerge from hybrid entities. Those are single business entities that are treated as transparent in one State and as opaque in another, likewise resulting in double non-taxation.¹⁹ A detailed analysis of such arrangements, however, falls outside the scope of this work.

This paper exclusively studies the relationship between linking rules and EU fundamental freedoms. Hence, the issue of compatibility with the non-discrimination principle regarding the deductibility of interests incorporated in Article 24(4) OECD Model Convention will be ignored.

Despite their affiliation with the topic, transfer pricing and thin capitalization fall beyond the scope of this paper.

Outline

The introduction sets out the background and the purpose, together with the relevant research questions addressed in this paper. The first part describes what hybrid financial instruments are and how they operate in a cross-border context. The second part covers linking rules, the solution to tax arbitrage proposed by the OECD in BEPS Action 2, and elaborates on how these would work in practice. The third and central part outlines the various steps of the analytical framework adopted by the ECJ. Following these steps, the enforceability of OECD linking rules is, subsequently, analysed in the light of EU law. The final part summarizes the essential findings, and provides an answer to the main research question.

I. HYBRID FINANCIAL INSTRUMENTS: A TECHNIQUE FOR TAX ARBITRAGE

¹⁹ Robert Danon, 'Qualification of Taxable Entities and Treaty Protection' (2014) 68(4/5) *BFIT* 192, 192.

Concept

Hybrid financial instruments present elements that may characterize them as equity as much as debt. Hence, they can be described as “a combined face of equity and debt”.²⁰ Several forms of hybrid financing exist. Examples not only include traditional instruments, such as redeemable shares which grant their holder a claim on a preferred dividend, but also more innovative instruments, such as profit participating loans which, unlike conventional loans, provide interest rates that are performance linked.²¹

Because they can differ in numerous dimensions including maturity, voting rights and return, a wide variety of hybrid instruments exists, ranging from pure equity (no maturity, no fixed return, right to vote) to pure debt (fix maturity, fix return, no right to vote).²²



Figure 1: Range of Hybrid Financial Instruments

From an economic perspective, hybrid financial instruments are often used, because they can adapt accurately to the needs of investors and issuers.²³ For example, profit participating loans are particularly advantageous in circumstances where the risk of the investment (for example, country risk) can provoke the need to divest or reduce the capital commitment as soon as possible.²⁴ In addition to economic reasons, tax motives also play a significant role in adopting hybrid financing. Indeed, in a cross-border context qualification, conflicts between two countries can lead to tax advantages.²⁵ In the remainder of this paper, the emphasis is placed on the tax consequences of hybrid financing.

²⁰ Antonio Russo and Omar Moerer, ‘Chapter 1: Introduction’ in Anuschka Bakker and Marc M Levey (eds), *Transfer Pricing and Intra-Group Financing* (IBFD 2012) 30.

²¹ Kahlenberg (n 10) 265.

²² Johannesen (n 11) 41.

²³ Bispo (n 8) 365.

²⁴ Russo (n 20) 30.

²⁵ Bispo (n 8) 365.

Classification issue

In most tax systems, dividends as compensation for equity are taxed in the hands of the payer, while interests as compensation for debt are taxed in the hands of the recipient since they are deductible by the payer.²⁶ Thus, from a tax perspective, the distinction between debt and equity is relevant.²⁷

Corporate tax systems classify financial instruments as either debt or equity. However, since hybrid financial instruments combine elements of both, their qualification for tax purposes can be challenging.²⁸ Moreover, this classification issue is a matter of domestic law which may differ between jurisdictions.²⁹

For example, in the Netherlands, the tax treatment of a financial instrument as either debt or equity depends, in principle, on its civil law classification.³⁰ However, following the case law of *De Hoge Raad* (the Dutch Supreme Court), loans can be qualified, in exceptional circumstances, as equity for tax purposes and, thus, the interest is regarded as a non-deductible dividend payment.³¹ Such a “recharacterisation” may occur regarding sham loans, loss financing loans and participating loans, provided that the following conditions are met:

- The height of the interest depends on the profit of the borrower; and
- The principal amount is subordinated to ordinary creditors; and
- The principal amount has no maturity or is perpetual.³²

In the US, courts look beyond the legal form of a transaction to determine its substance. This so-called “substance-over-form” principle has been upheld by US case law for decades.³³ According to this principle, the tax treatment of a transaction is determined by its economic substance. Therefore, the Internal

²⁶ Sven Bärsch, *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-Border Context* (Springer 2012) 1.

²⁷ Gabriël van Gelder and Boudewijn Niels, ‘Tax Treatment of Hybrid Financial Instruments’ (2013) 15(4) *Derivatives & Financial Instruments* 140, 140.

²⁸ Martin Six, ‘Hybrid Finance and Double Taxation Treaties’ (2009) 63(1) *BFIT* 22, 22.

²⁹ Peter Blessing, ‘The Debt-Equity Conundrum – A Prequel’ (2012) 66(4) *BFIT* 198, 203.

³⁰ HR, 27 Jan 1988, No 23919, *BNB* 1988: 217 (“*Unileverarrest*”); HR, 8 Sep 2006, No 42015, *BNB* 2007: 104 (“*Kaspische Zee-Arrest*”).

³¹ *ibid.*

³² Michiel van der Breggen, ‘Chapter 13: Netherlands’ in Bakker (n 20) 429.

³³ SC, 1935, *Gregory v Helvering*, 293 US 465 (1935); SC, 1978, *Frank Lyon Co v United States*, 435 US 561 (1978).

Revenue Code provides a list of characteristics which courts can consider when assigning a hybrid instrument to either the debt or equity group.³⁴

Tax arbitrage

Due to the lack of coordination between jurisdictions regarding their qualification (for example, the Netherlands and the US), hybrid financing can be used for tax arbitrage purposes.³⁵ As mentioned above, this concept refers to the act of taking advantage of differences between tax systems to minimize taxes.³⁶ Indeed, for multinationals, hybrid financing leads to tax planning opportunities, because qualification conflicts may result in double non-taxation. For instance, a hybrid financial instrument is considered debt in the country of the payer while regarded as equity in the country of the recipient. Consequently, no taxation is due, since the payment is deductible in the hands of the payer while being exempt in the hands of the recipient.³⁷ The OECD provides the following example regarding these so-called “deduction/non-inclusion schemes”:³⁸

³⁴ Internal Revenue Code (IRC), s 385(b).

³⁵ OECD (n 7) 5.

³⁶ Bispo (n 8) 367.

³⁷ Johannesen (n 11) 40.

³⁸ OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements* (Paris, OECD Publishing 2014) 33.

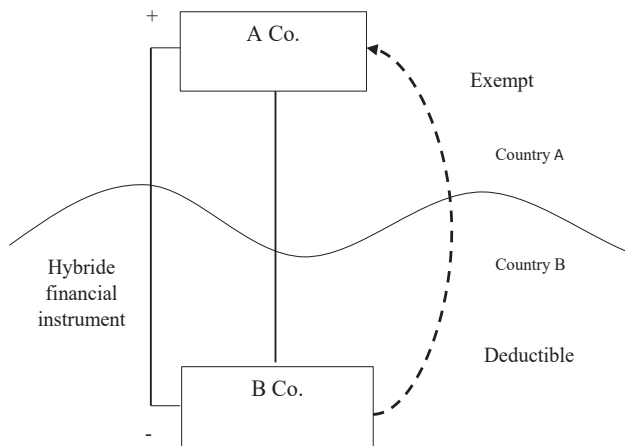


Figure 2: OECD Example deduction/non-inclusion scheme

B Co (resident in Country B) issues a hybrid financial instrument to A Co (resident in Country A). The instrument is regarded as debt for the purposes of Country B's law and Country B provides a deduction for interest payments made under the instrument, while Country A's law grants an exemption regarding the same payments.³⁹ Hence, no taxes are due on the financial compensation from B Co. to A Co.

The aforementioned example provided by the OECD is reasonably straightforward. In practice, however, more elaborate schemes are used to explain the same outcome. In this regard, the *PepsiCo* case can be used as a case study.

Case study: *PepsiCo*

In the *PepsiCo* case,⁴⁰ the US Tax Court examined the characterization of Pepsi's advance agreements for tax purposes. The group structure of the soft drink multinational can be structured as follows:

³⁹ *ibid* 34, para 53.

⁴⁰ *PepsiCo Puerto Rico Inc et al v Commissioner* (TC Memo 2012-269) <<http://www.ustaxcourt.gov/InOpHistoric/pepsicomemo.TCM.WPD.pdf>> accessed 24 June 2016.

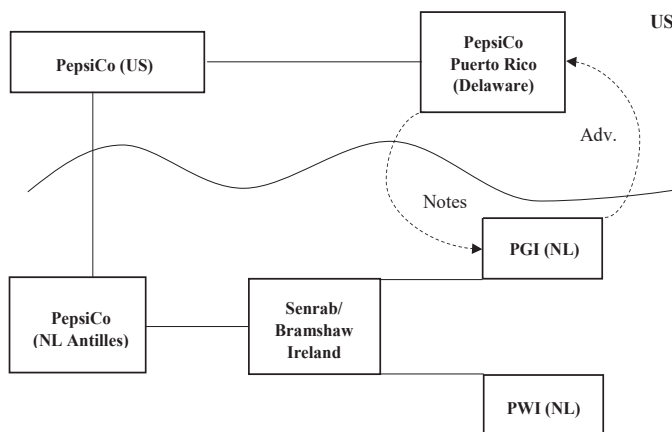


Figure 3: Group Structure PepsiCo

Adv. = Advanced Agreement

PWI = PepsiCo Worldwide Investments

PGI = PepsiCo Global Investments

In the mid-1990s, the US company PepsiCo wanted to establish its brand in Asia and Eastern Europe. Instead of moving funds from the US directly to its overseas investments, which would create withholding tax liability, PepsiCo restructured its international operations so that the overseas investments were financed by Dutch holding companies (PGI). The latter, in turn, were funded by PepsiCo Puerto Rico (PPR) who provided notes in exchange for advanced agreements. The Dutch authorities perceived this cross-border transaction between the US and the Netherlands as debt. PepsiCo assumed that the payments received from its Dutch subsidiaries pursuant to the advance agreements would be treated as dividends in the US and, as a result, be exempt from taxation. The Internal Revenue Service, however, disagreed and claimed \$363 million of PepsiCo and PPR in unpaid taxes for years between 1998 and 2002.

The case was brought before the US Tax Court which ruled in favour of PepsiCo.⁴¹ Indeed, after identifying 13 factors to consider in characterising the instrument, the court argued that several factors, including the long maturity

⁴¹ Patrick Temple-West and Howard Goller, 'PepsiCo Wins Debt-vs-Equity Dispute in US Tax Court' (*Reuters*, 25 September 2012) <<http://www.reuters.com/article/us-pepsi-tax-idUSBRE88O19R20120925>> accessed 24 June 2016.

dates and the subordination of payments to debt, established uncertainty of repayment. This, in turn, allows the court to label the advance agreements as equity.⁴²

The *PepsiCo* case clearly illustrates how hybrid financial instruments can successfully be used for tax planning purposes. Indeed, due to the lack of coordination between the Netherlands and the US regarding the tax treatment of the advance agreements, PepsiCo was able to reduce its tax liability significantly. A more detailed description of the debt-equity analysis of the court in the *PepsiCo* case, however, falls outside the scope of this paper. The next chapter examines the solution suggested by the OECD to cope with this issue of tax arbitrage.

II. SOLUTION PROPOSED BY THE OECD

In response to tax arbitrage, the OECD proposed rules that make the qualification of a particular payment conditional on its qualification in the other state. These so-called “linking rules” first appeared in the “Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues” report published by the OECD in 2012.⁴³ In this report, changes to domestic law were suggested to counter “hybrid mismatch arrangements” which were defined by the OECD as “arrangements exploiting differences in the tax treatment of instruments, entities or transfers between two or more countries”.⁴⁴

Following the release of the report named “Addressing Base Erosion and Profit Shifting” (BEPS),⁴⁵ the OECD continued its work on hybrid mismatch arrangements. Indeed, among the other proposed actions, BEPS Action 2 of BEPS addressed the issue of hybrid mismatches.⁴⁶ In addition to two Public Discussion Drafts,⁴⁷ the OECD launched another report in 2014 suggesting

⁴² Joe Dalton, ‘Does Pepsi’s Tax Court Win Reveal Super Factor in Debt-Equity Cases?’ (*International Tax Review*, 4 October 2012) <<http://www.internationaltaxreview.com/Article/3098235/Has-PepsiCos-US-Tax-Court-win-revealed-super-factor-in-deciding-debt-vs-equity-cases.html>> accessed 24 June 2016.

⁴³ OECD (n 7) 11.

⁴⁴ *ibid* 5.

⁴⁵ OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris, OECD Publishing 2013).

⁴⁶ Reinout de Boer and Otto Marres, ‘BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements’ (2015) 43(1) *Intertax* 14, 14.

⁴⁷ OECD, *Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* *International Organizations* (Paris, OECD

potential solutions to different types of hybrid mismatches including those resulting from hybrid financial instruments.⁴⁸ However, it was not until October 2015 that the OECD published its final report on Action 2 entitled “Neutralising the Effects of Hybrid Mismatch Arrangements”.⁴⁹

The first part of this report provides an overview of the OECD recommendations for domestic law. Regarding the deduction/non-inclusion schemes resulting from the utilization of hybrid financial instruments, the OECD suggested the implementation of domestic linking rules. Such rules aim to connect the domestic tax qualification of a cross-border hybrid financial instrument with the tax treatment in another jurisdiction.⁵⁰

The rules suggested by the OECD consist of a “primary rule” and a “defensive rule”.⁵¹ The primary rule allows a Member State to deny the payer a deduction for payments made under a hybrid financial instrument. Therefore, the right to tax is re-allocated by the primary rule to the country of the payer. Conversely, the defensive rule implies that the country of the recipient should include the “dividends” of the hybrid financial instrument in the taxable base of the recipient. However, to prevent the taxpayer from double taxation, the latter rule may only be applied either when no primary rule exists in the counterparty jurisdiction or when the existing rule is not applicable to the financial instrument in question. Hence, the application of the primary rule has priority over the application of the defensive rule.

Furthermore, the scope of the OECD proposal is limited to related parties of which the shareholding in the holding company exceeds 25%.⁵² Nevertheless, OECD linking rules likewise apply to any other entity that is a party to any structured arrangement that has been developed to shift profits and reduce the tax burden.⁵³

In addition to the OECD, the EU also undertook initiatives against situations of double non-taxation deriving from mismatches. In June 2014, the ECOFIN Council agreed on an amendment to the Parent-Subsidiary (PS)

Publishing, 2014); OECD, *Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues) International Organizations* (Paris, OECD Publishing, 2014).

⁴⁸ OECD (n 38).

⁴⁹ OECD (n 14).

⁵⁰ *ibid* 14.

⁵¹ Deloitte, ‘BEPS Action 2, Neutralising the Effects of Hybrid Mismatch Arrangements’ (*Tax Alert*, 16 October 2015) <<https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-oecd-16-october-2015.pdf>> accessed 7 July 2016.

⁵² OECD (n 7) 113.

⁵³ *ibid* 105.

Directive (2011/96) implementing a rule that links the tax treatment of a payment to its treatment in another State.⁵⁴ The new EU provision in the PS Directive differs from the OECD recommendations in the sense that it does not make a distinction between a “primary rule” and a “defensive rule”. Instead, it merely obliges Member States to implement a linking rule with a defensive nature.⁵⁵ A similar provision is included in the proposal for an EU Anti-Avoidance Directive, published on 28 January 2016.⁵⁶ The proposal sums up a number of measures designed to implement BEPS Action Plan, from CFC legislation to hybrid mismatch rules. Nevertheless, since the legality of secondary EU law remains outside the scope of this paper, no further value is attached to the EU initiatives.

III. ENFORCEABILITY OF OECD LINKING RULES

The previous chapter examined the solution suggested by the OECD to address the issue of tax arbitrage. This chapter further analyses whether Action 2 will successfully achieve its goal. To answer this question, the enforceability of OECD linking rules is determined in the light of EU law. In this regard, the analytical framework of the ECJ will be used as a benchmark.

Primacy of EU law

Direct taxation (i.e. income taxation) is regarded as a matter of each Member State’s sovereignty, while the authority to regulate indirect taxation (i.e. value added tax) belongs to the EU.⁵⁷ Nevertheless, for direct tax rules to be enforceable domestically, it is settled ECJ case law that Member States need to respect supranational EU law.⁵⁸ This follows from the “primacy of EU law” principle. This, in turn, goes back to the milestone case *Van Gend & Loos* in

⁵⁴ Council Directive 2014/86/EU amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [2014] OJ L 219.

⁵⁵ Council Directive (n 54) art 1 (1)(a).

⁵⁶ Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] COM/2016/026 final.

⁵⁷ Mathieu Isenbaert, *EC Law and the Sovereignty of the Member States in Direct Taxation* (IBFD 2008) 220.

⁵⁸ Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651, para 19; Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, para 29.

which the Court recognised for the first time that EU law prevails over national law.⁵⁹

When assessing the relationship between direct tax laws and EU law, the ECJ considers whether they constitute a breach of the EU fundamental freedoms. The TFEU comprises the following fundamental freedoms:⁶⁰

- Free movement of goods (Article 28);
- Free movement for workers (Article 45);
- Right of establishment (Article 49) and freedom to provide services (Article 56);
- Free movement of capital (Article 63).

These four freedoms constitute the basis on which the ECJ assesses the relationship between domestic law and EU law. The question as to which fundamental freedom is at stake in each case is relevant, as only the free movement of capital applies to third-country situations and is, therefore, not limited to pure EU cases. However, as the ECJ has yet to rule in a general manner on the hierarchy between the fundamental freedoms, the question concerning the prevalence of any freedom will receive no further attention throughout this paper.

Furthermore, in performing its assessment, the ECJ adopts a self-developed analytical framework. This framework will likewise be used in the paragraphs below to determine the enforceability of OECD linking rules in the light of EU law. Figure 4 below provides an overview of the analytical framework adopted by the ECJ.

⁵⁹ Case 26/62 *Van Gend & Loos* [1963] CMLR 105.

⁶⁰ TFEU (n 16).

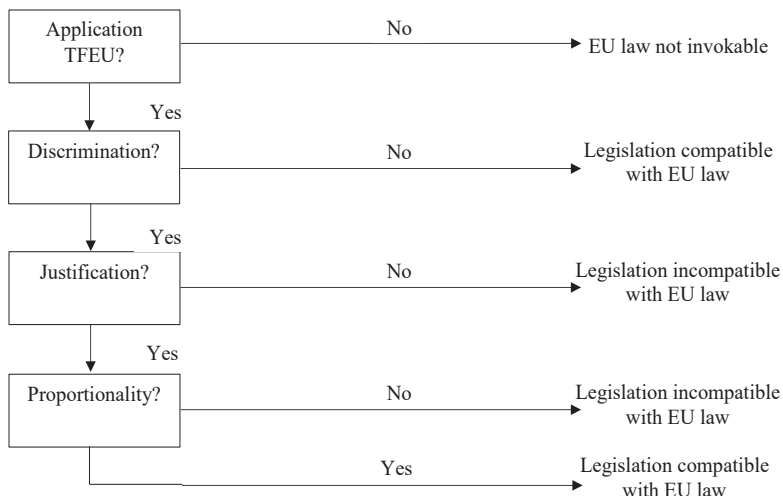


Figure 4: Analytical Framework ECJ

Before invoking EU law against a potentially discriminatory measure, one needs to determine the existence of a cross-border element. Indeed, the application of the EU treaties is conditioned on the existence of a cross-border element.⁶¹ Given the inherent cross-border context in which hybrid mismatches arise, one can assume that the EU founding treaties, including the TFEU which incorporates the fundamental freedoms, are applicable. In the next step, the question arises whether a measure should be perceived as discriminatory.

(C)overt discrimination

According to the ECJ, each of the fundamental freedoms encompasses a non-discrimination principle, which implies that in tax matters “comparable situations must not be treated differently and different situations must not be treated in the same way unless such treatment is objectively justified”.⁶² This principle not only bans overt discrimination on grounds of nationality, but also covert discrimination. A measure gives rise to covert discrimination when it is

⁶¹ Case C-175/78 *R v Saunders* [1979] ECR 1129, para 11.

⁶² Case C-80/94 *Wielockx v Inspecteur der Directe Belastingen* [1995] ECR I-2493, para 17.

“intrinsically liable to affect” cross-border situations more than pure domestic situations.⁶³

Regarding linking rules, a deduction or an exemption might be denied if a hybrid instrument is treated differently under the laws of two or more jurisdictions. Since mismatches by their nature arise exclusively in a cross-border context,⁶⁴ no primary rule or defensive rule can be triggered in purely domestic situations. Indeed, contrary to taxpayers operating abroad, those who only conclude contracts domestically, do not bear the risk of losing their tax benefits following the application of linking rules. Hence, despite their neutral formulation, one would expect that linking rules are intrinsically liable to affect cross-border situations and, thus, give rise to covert discrimination.

Whether linking rules are discriminatory, depends ultimately on the comparability analysis carried out by the ECJ.⁶⁵ Indeed, discrimination only arises when comparable situations are treated differently for tax purposes, unless such difference is objectively justified.⁶⁶ Therefore, the comparability of the domestic situation with the cross-border situation is critical in analysing the existence of discrimination. In that regard, the ECJ adopts two approaches: the “per-country approach” which considers the situation of the taxpayer on a stand-alone basis, and the “overall approach” which looks at the cross-border situation as a whole.⁶⁷

Per-country approach

The first approach under which the ECJ carries out its comparability analysis is the per-country approach. According to this approach, no consideration is given to the different tax treatment in other Member States. Instead, it requires that

⁶³ Niels Bammens, *The Principle of Non-Discrimination in International and European Tax Law* (IBFD 2012) 507; Paula Régil, ‘BEPS Actions 2, 3 and 4 and the Fundamental Freedoms: Is There a Way Out’ (2016) 56(6) *European Taxation* 230, 231.

⁶⁴ Otmar Thömmes and Alexander Linn, ‘The New German DCL and Dividend Matching Rules and EU law’ (2014) 42(1) *Intertax* 28, 33.

⁶⁵ Barreiro Carril, ‘National Tax Sovereignty and EC Fundamental Freedoms: The Impact of Tax Obstacles on the Internal Market’ (2010) 38(2) *Intertax* 105, 106.

⁶⁶ Case C-354/95 *National Farmers’ Union and Others* [1997] ECR I-4559, para 61.

⁶⁷ Jessica Di Maria, ‘Comparability in the Case of Hybrid Mismatch: In Search of an Approach Suitable for the Current European Landscape’ in Kasper Dziurdz and Christoph Machgraber (eds), *Non-Discrimination in European and Tax Treaty Law* (Linde Verlag 2015) 186; Carril (n 65) 106.

the ECJ only examines the tax treatment of a stand-alone taxpayer in contrast with the situation of comparable taxpayers from the same jurisdiction.⁶⁸

The Court used this approach in the *Eurowings* case.⁶⁹ In this case, a German-resident company leasing aircrafts from a lessor in Ireland was subjected to a higher trade tax than a similar company who leased the same goods from a lessor in Germany. According to the Court, this measure violated the freedom to provide services. Germany tried to justify its difference in tax treatment by arguing that the Irish-resident lessor was subjected to lower taxation than in Germany. The Court, however, dismissed this argument, because “[a]ny 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”.⁷⁰

In short, in *Eurowings*, the ECJ analysed the disadvantage regarding transactions with non-residents under German law on a stand-alone basis and, thus, disregarded the potentially favourable tax treatment in other Member States. The Court adopted the same reasoning in its later case law. Regarding financial benefits reserved for recipients of dividends of domestic companies, the ECJ argued in the *Lenz* case that “the level of taxation of companies established [abroad] cannot justify a refusal to grant those same financial advantages to persons receiving revenue from capital paid by those latter companies”.⁷¹

Overall approach

As opposed to the per-country approach, the overall approach implies that the ECJ examines the cross-border situation as a whole when carrying out its comparability analysis. Thus, in addition to the tax treatment of a taxpayer in their country of residence, consideration is given to the different tax treatment in other Member States.⁷² Once the overall tax burden of a taxpayer or group of taxpayers is determined in the light of different jurisdictions, the ECJ looks at similar situations to assess whether discrimination exists.

⁶⁸ Carril (n 65) 109.

⁶⁹ Case C-294/97 *Eurowings* [1999] ECR I-7449.

⁷⁰ *ibid* para 44.

⁷¹ Case C-315/02 *Lenz* [2004] ECR I-7063, para 42.

⁷² Carril (n 65) 111.

The ECJ first introduced the overall approach in the *Schumacker* case.⁷³ This case concerned the denial of tax benefits for family circumstances by German tax authorities to a Belgian resident who earned 90% of his income from work carried out in Germany. Under German tax law, such advantages were only available to residents in Germany. According to Schumacker, this constituted a breach of freedom of movement for workers, because he would receive tax benefits as a German resident due to his family circumstances. For its assessment of possible discrimination, the Court looked at the tax treatment of Schumacker in Belgium. It determined that Belgium could not grant any benefits for family circumstances, as Germany was allowed to tax Schumacker's profits under the Belgium-Germany double tax treaty.⁷⁴ Therefore, by taking into account the overall tax treatment of Schumacker, the ECJ decided that the State of employment, Germany, was obliged to provide the tax benefits in question.

The ECJ followed a similar approach in the *Schempp* case.⁷⁵ In this case, the ECJ accepted German rules, under which the deductibility of alimony payments depended upon the taxable outcome in another Member State. Mr Schempp was a German resident taxpayer who paid alimony to his former spouse in Austria. Under German law, maintenance payments were deductible, provided that they were taxed in the hands of the recipient. Since such payments were not taxed in Austria, Mr Schempp was unable to claim a deduction in his German tax return. According to Mr Schempp, a deduction would have been granted if his former spouse was a resident of Germany. Despite this existing difference in treatment as opposed to situations where alimony is paid to German residents, the Court concluded that German law was not discriminatory due to the lack of comparability between the two situations.⁷⁶ Indeed, in contrast to Austrian law, German law requires that alimony payments are subject to taxation. Because of this different tax treatment, alimony payments to an Austrian resident cannot be compared to similar payments to a German resident. Since discrimination can only arise in comparable situations, the Court found that German law was compatible with EU law.⁷⁷

Along the lines of the judgement in *Schumacker* and *Schempp*, one would expect that a cross-border situation in which a mismatch arises regarding hybrid financial instruments, cannot be compared to a domestic situation where no mismatch exists regarding the same instrument.⁷⁸ Due to this lack of

⁷³ Case C-279/93 *Schumacker* [1995] ECR I-225.

⁷⁴ *ibid* paras 36-38.

⁷⁵ Case C-403/03 *Schempp* [2005] ECR I-06421.

⁷⁶ *ibid* para 35.

⁷⁷ *ibid* para 39.

⁷⁸ Di Maria (n 67), 184.

comparability, linking rules which deny tax benefits in cross-border situations should not be considered discriminatory.

Comparability in the event of tax arbitrage

Regarding OECD linking rules, the approach employed by the ECJ in carrying out its comparability analysis will have a significant impact on its findings. If the Court follows a per-country approach which focuses on the situation of the taxpayer on a stand-alone basis, one would expect that it will ignore the tax treatment of the counterparty jurisdiction when assessing the discriminatory nature of linking rules. Consequently, a discrimination arises between cross-border situations and domestic situations since two comparable taxpayers are subjected to a different tax treatment. Conversely, under an overall approach which examines the cross-border situation as a whole, one would expect that, along the lines of the judgement in *Schumacker* and *Schempp*, the ECJ will perceive cross-border hybrid mismatches as incomparable to domestic situations regarding the same hybrid instrument, but without classification conflict. Due to this lack of comparability, linking rules which deny tax benefits in cross-border situations should not be considered discriminatory.

As the ECJ has not shown preference for either of the aforementioned approaches, legal uncertainty prevails regarding the question whether or not the implementation of OECD linking rules creates discrimination and, thereby, infringes the EU fundamental freedoms. Hence, for the sake of legal certainty, the ECJ should take a clear position when performing its comparability analysis in the future. In this author's view, since policy considerations supporting anti-hybrid mismatch measures exist, the overall approach should be upheld. Indeed, tax arbitrage not only results in significant revenue loss, but it also causes distortion of competition between companies subjected to different tax avoidance requirements. Furthermore, it violates the principle of neutrality, since taxpayers are encouraged to invest abroad rather than in their home country, which in turn causes a negative impact on economic efficiency.⁷⁹ However, Di Maria raises one convincing argument to support the per-country approach.⁸⁰ She argues that the per-country approach corresponds to the current European landscape in which Member States can freely draw up their tax policies. Indeed, because they enjoy sovereignty in direct taxation, Member States cannot be required to adjust their tax rules to those of other jurisdictions.

⁷⁹ OECD (n 14) 11.

⁸⁰ Di Maria (n 67) 187.

Therefore, the overall approach of the Court should not be perceived desirable in a non-harmonised European tax environment.⁸¹

In any case, considering the preeminent risk that the ECJ finds linking rules discriminatory following the per-country approach, it is worth examining the next step of the ECJ analytical framework, namely the question as to whether a potential restriction can be justified on grounds of an overriding public interest.

Justification of potential discrimination

Rule of reason

The ECJ has adopted a doctrine of justification (“rule of reason”) to justify breaches of the fundamental freedoms resulting from discriminatory measures. Indeed, in the *Cassis de Dijon* case,⁸² the Court accepted for the first time unwritten justification grounds which constitute an overriding reason in the public interest.⁸³ Since then, a variety of justification grounds have been introduced. However, this section will only focus on those which are closely related to tax arbitrage, namely the prevention of tax abuse and the fiscal coherence.

As a preliminary point, one could argue that ensuring single taxation constitutes an overriding reason which justifies the potential restriction of the EU basic freedoms. Nevertheless, the ECJ has not yet recognized such justification ground.⁸⁴ Indeed, as the Court has stated, “it is settled case law that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company”.⁸⁵ Consequently, the mere fact that hybrid financial instruments can reduce the overall tax liability of a taxpayer due to their different tax treatment in another Member State, does not justify a potential restriction. In addition to low taxation, other reasons that are connected to hybrid mismatches, but have been

⁸¹ *ibid* 189.

⁸² Case C-120/78 *Rewe-Zentral AG* [1979] ECR 649.

⁸³ *ibid* para 8.

⁸⁴ Jakob Bundgaard, ‘Hybrid Financial Instruments and Primary EU Law – Part 2’ (2013) 53(12) *European Taxation* 587, 587.

⁸⁵ Case C-196/04 *Cadbury Schweppes* [2006] ECR I-07995, para 49 (citations omitted).

rejected by the Court, include loss of tax revenue,⁸⁶ as well as double non-taxation.⁸⁷

Prevention of tax abuse

The prevention of tax abuse is the first justification accepted by the ECJ, which is also relevant to the field of hybrid mismatches. In *Cadbury Schweppes*, the ECJ argued that a restriction on the fundamental freedom of establishment may be justified by the prevention of tax avoidance, provided that it specifically targets “wholly artificial arrangements which do not reflect economic reality”.⁸⁸ Thus, to be perceived justifiable by the ECJ, a restricting measure that prevents tax avoidance cannot have a general scope. Instead, its application must be limited to “wholly artificial arrangements”. The latter do not reflect economic reality and have the objective of circumventing tax laws.⁸⁹

In the same case, the ECJ identified two factors that determine whether a transaction constitutes an artificial arrangement: the subjective element and the objective element. The subjective element refers to the intention of the taxpayer to avoid taxes, while the objective factor relates to the failure to comply with elements ascertainable by third parties which suggest that the arrangement corresponds to economic reality.⁹⁰ Both elements need to be evaluated on a case-by-case basis. An example of a wholly artificial arrangement proposed by the court is a “letterbox”,⁹¹ which is established merely for tax purposes and does not conduct economic activity. Additionally, restrictive tax measures need to comply with the principle of proportionality. Therefore, taxpayers must be given the opportunity to prove that any genuine economic justification exists for its actions.⁹²

In light of the *Cadbury Schweppes* case, it seems unlikely that OECD linking rules can be justified by the prevention of tax avoidance. Indeed, although they may be used to obtain tax savings, hybrid financial instruments usually serve the objective of financing investments and economic activities.⁹³ Thus, not all

⁸⁶ Case C-422/01 *Skandia* [2003] ECR I-6817, para 53.

⁸⁷ Marjaana Helminen, ‘EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements’ (2015) 3 BTR 325, 332.

⁸⁸ *Cadbury Schweppes* (n 85) para 51.

⁸⁹ *ibid* para 55.

⁹⁰ *ibid* para 64.

⁹¹ *ibid* para 68.

⁹² Case C-524/04 *Thin Cap Group Litigation* [2007] ECR I-2107, para 82.

⁹³ *Bundgaard* (n 84) 591.

hybrid financial instruments can be considered “wholly artificial arrangements” as they will generally fail to pass the objective test. Limiting the scope of their linking rules to wholly artificial arrangements, would allow Member States to comply with the *Cadbury Schweppes* doctrine. However, one would expect that this undermines the effectiveness of linking rules since most financial instruments would fall outside their scope.

Alternatively, Member States could avoid the strict “wholly artificial arrangement” requirement of the *Cadbury Schweppes* judgement by invoking the prevention of the tax abuse justification in combination with the preservation of a balanced allocation of taxing rights. The latter, which was first introduced in the *Marks & Spencer* case in 2005,⁹⁴ entails that Member States have the right to levy taxes on either a tax subject or a tax object (or both) that has a reasonable tie with its tax jurisdiction.⁹⁵ The ECJ accepts that, without fulfilling the wholly artificial requirement, the prevention of tax abuse can still justify a discrimination provided that the balanced allocation ground is met. Indeed, in determining that Belgian transfer pricing regulation complies with EU law, the ECJ used a joint assessment of both justification grounds in the *SGI* case.⁹⁶ Regarding the artificial arrangement requirement, the Court argued that “[e]ven if the specific purpose of a national legislation is not to exempt from tax benefits prescribed in the law fictitious arrangements that are not economically viable [...] such legislation may nonetheless be considered justified in this context by the aim to prevent tax avoidance in conjunction with the aim to maintain a balanced allocation of taxing rights between member states”.⁹⁷ The Court followed a similar approach in the *Oy AA* case concerning the Finnish cross-border loss relief.⁹⁸

Following this case law, one could argue that, regarding OECD linking rules, the ECJ would likewise adopt a joint assessment of justification grounds. However, it remains undetermined whether the ECJ will allow the balanced allocation of taxing rights as a justification ground for linking rules. As pointed out by Bundgaard,⁹⁹ their intention is not to protect a State’s tax claim regarding the activities carried out on its territory, but to eliminate potential tax savings that arise from a divergence in qualification between countries. In other words, OECD linking rules are adopted to counter double non-taxation in the OECD

⁹⁴ *Marks & Spencer* (n 58).

⁹⁵ Case C-311/08 *Société de Gestion Industrielle* [2010] ECR I-487, para 60.

⁹⁶ *ibid* para 66.

⁹⁷ Maria Hilling, ‘Justifications and Proportionality: An Analysis of the ECJ’s Assessment of National Rules for the Prevention of Tax Avoidance’ (2013) 41(5) *Intertax* 294, 301 with reference to *Société de Gestion Industrielle* (n 95) para 66 (emphasis added).

⁹⁸ Case C-231/05 *Oy AA* [2007] ECR I-6373, para 63.

⁹⁹ Bundgaard (n 84) 589.

Member States altogether, rather than to protect the tax base of single Member States. Therefore, it seems highly unlikely that the ECJ will accept the balanced allocation of taxing right, in combination with the prevention of tax abuse as potential justification grounds for linking rules.

Fiscal coherence

One of BEPS's policy goals is establishing "international coherence in corporate income taxation".¹⁰⁰ Like the OECD, the ECJ recognises the importance of fiscal coherence by accepting it as a justification ground. The coherence justification allows Member States to maintain a symmetry between the taxability of an income and the deductibility of the corresponding expense.¹⁰¹ The ECJ first introduced this justification ground in the *Bachmann* case.¹⁰² This case dealt with the relation between the deductibility of insurance premiums paid in Belgium and the taxability of the pensions paid by insurers. According to Belgian law, contributions paid to an insurer under a pension contract in Belgium were deductible when the pensions related to the contributions were likewise taxable in Belgium. *Bachmann*, who concluded a pension contract with a non-Belgian insurance company, was not allowed to deduct his contributions as they were not paid in Belgium. According to the Court, the discriminatory tax treatment of insurance contributions was justified by fiscal coherence, as Belgium had no certainty that it would be able to tax the amounts paid by foreign insurers.¹⁰³

Regarding OECD linking rules, fiscal coherence could be evoked as a potential justification since a connection arises between the tax benefit of one company and the tax disadvantage of another company. However, in later case law, the Court refined the coherence ground by requiring the existence of a direct link between the tax benefit and the fiscal burden. Initially, such a direct link requires that the tax levy and tax benefit must be present in the same category of tax and with regard to the same taxpayer.¹⁰⁴ Hence, the ECJ has rejected in the past the existence of a direct link between the right to tax profits

¹⁰⁰ OECD (n 45) 15.

¹⁰¹ Helminen (n 87) 335.

¹⁰² Case C-204/90 *Bachmann* [1992] ECR I-249.

¹⁰³ *ibid* para 28.

¹⁰⁴ Dennis Weber, 'An Analysis of the Past, Current and Future of the Coherence of the Tax System as Justification' (2015) 24(1) EC Tax Review 43, 51 (with references).

of a subsidiary abroad and the deduction of losses of a subsidiary located in the United Kingdom (UK), because it concerned different taxpayers.¹⁰⁵

Following the strict reasoning of the Court, one would expect that a direct link likewise does not exist regarding OECD linking rules, as both the primary rule and the defensive rule do not relate to the same taxpayer. Indeed, the tax benefit of one subsidiary is aligned to the tax treatment of the hybrid instrument in the hands of another subsidiary. Consequently, numerous scholars have argued that, due to the lack of “direct link”, OECD linking rules cannot be justified on the ground of fiscal coherence.¹⁰⁶

However, one cannot simply ignore the fact that, over the years, the Court has adopted a less rigorous approach regarding the direct link requirement. The *Marks & Spencer* case of 2005, for example, concerned the deductibility of losses in foreign subsidiaries against its taxable profits in the UK.¹⁰⁷ In that case, the ECJ found the refusal of the UK to allow the claim of Marks & Spencer justifiable on three different grounds. In addition to the prevention of tax abuse and the double deduction of losses, the Court accepted the denial on the basis that “profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system” (even though they did not concern the same taxpayer).¹⁰⁸ Along the same lines, the Court has considered the coherence justification in numerous cases regarding the distribution of dividends without referring to the existence of a direct link in the event of one and the same taxpayer.¹⁰⁹

Moreover, the ECJ seems to abandon the condition of a direct link regarding a single taxpayer even further by moving the question of fiscal coherence from the national level to the broader level of States entering into tax treaties.¹¹⁰ Indeed, in the *Danner* case, the Court ruled that, due to the double taxation conventions “fiscal cohesion is no longer established in relation to one and the same person... but is shifted to another level, that of the reciprocity of the rules applicable in the Contracting States”.¹¹¹ Neyt and Peeters argue that the Court applied a similar reasoning in case *K*.¹¹² In that case, the ECJ found a

¹⁰⁵ Case C-264/96 *Imperial Chemical Industries* [1998] ECR I-4695.

¹⁰⁶ Régil (n 63) 241; Helminen (n 87) 336; Bundgaard (n 84) 589.

¹⁰⁷ *Marks & Spencer* (n 58).

¹⁰⁸ *ibid* para 43.

¹⁰⁹ Case C-493/09 *Commission v Portugal* [2011] ECR I-9247, paras 35-41; Case C-284/09 *Commission v Germany* [2011] ECR I- 9879, paras 84-93.

¹¹⁰ Mattias Dahlberg, *Direct Taxation in Relation to the Freedom of Establishment and Free Movement of Capital* (Kluwer International 2005) 132.

¹¹¹ Case C-136/00 *Danner* [2002] ECR I-8147, para 41 (emphasis added).

¹¹² Robert Neyt and Steven Peeters, ‘Balanced Allocation and Coherence: Some Thoughts in Light of *Argenta* and *K*’ (2014) 23(2) EC Tax Review 64, 70.

direct link between the capital losses at the occasion of the sale of real estate in France and its potential capital gains.¹¹³ According to the authors, one could posit that, from the viewpoint of the Member States concerned, the losses and profits are not directly linked “on the level of each taxpayer individually, but on a higher level between all profits and all losses with respect to their respective foreign real estate”.¹¹⁴

In accordance with the above case law, AG Kokott claimed that the coherence justification is applicable even if the fiscal burden and tax advantage do not regard to the same taxpayer, provided that a twofold prerequisite is met.¹¹⁵ Firstly, it is required that tax advantage and tax burden concern the same income or the same economic process. Secondly, the tax disadvantage which accrues to one taxpayer needs to be “real and in the same amount” as the tax advantage accruing to the other taxpayer.

Since linking rules align the tax treatment of a hybrid financial instrument in one jurisdiction with the tax outcome of the same instrument in another jurisdiction, no concerns shall arise regarding the first condition. However, the same cannot be said for the second requirement. Indeed, due to different corporate income tax rates among Member States, the tax advantage of one taxpayer will differ from the tax disadvantage accruing to the other. The application of the primary rule can be used as an example to illustrate this.

Suppose a payment of 100 EUR is deductible at the level of the payer at a 10% rate, while the corresponding amount is taxed at the level of the recipient at a 30% rate. Due to a mismatch, the recipient is granted a tax exemption regarding the full amount which results in a tax benefit of 30 EUR (100 x 30%). Under the primary rule the deduction of the same amount in the hands of the payer will be rejected, accruing a tax disadvantage to the latter of only 10 EUR (100 x 10%).

The most effective method to ensure equality between the tax advantage and the tax disadvantage would be the harmonisation of the corporate income tax rate among OECD Member States. However, considering the refusal of a Common Consolidated Corporate Tax Base,¹¹⁶ it seems highly unlikely that, even within the EU, States would be willing to harmonize their income tax rates. Whether this precludes the existence of a direct link regarding linking rules, depends on the value that the ECJ attaches to the difference in income tax rate

¹¹³ Case C-322/11 K [2013].

¹¹⁴ Neyt (n 112).

¹¹⁵ Opinion of AG Kokott in Case C-319/02 *Manninen* [2004] ECR I-7477, para 61. See also Opinion of AG Madura in the *Marks & Spencer* case (n 58), para 71.

¹¹⁶ Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) COM (2011) 121/4.

between the country of the payer, where the payment is deducted, and the country of the recipient, where the payment is taxed. At least in the *Schempp* case, the Court did not pay much attention to these different rates. Therefore, German law which made the deductibility of alimony payments depend on the taxable outcome in another Member State was found compatible with EU law. Regarding linking rules, one could argue that, in line with *Schempp*, the Court will identify a direct link between the fiscal burden and the tax benefit by disregarding the difference in tax rates among the countries concerned.

Although the current version of the linking rules successfully eliminates situations of double non-taxation, the same cannot be said for double taxation. Indeed, pursuant to the defensive rule, the country of the recipient must include the “dividends” of the hybrid financial instrument in the taxable base of the recipient when these are deductible in the hands of the payer. However, there is no provision in place that requires the country of the recipient to provide an exemption if the payment is not deductible in the country of the payer following the application of tax deductibility restrictions (for example, thin cap and transfer pricing regulation). One could argue that the one-sided nature of the linking rules prevents the existence of fiscal coherence. Indeed, as noted by AG Kokott, fiscal coherence generally entails “no more than avoiding double taxation or ensuring that income is actually taxed, but only once (the principle of only-once taxation)”.¹¹⁷ Along the same lines, Helminen argues that a coherent tax system implies that “always when a payment is deductible, the payment is taxable as regards the recipient, and always when a payment is not deductible, it is exempt as regards the recipient”.¹¹⁸ Following this reasoning, linking rules can only be justified if they work bilaterally in the way that one State is obliged to provide a tax benefit for a payment when the other State refused to give one regarding the same payment. Consequently, Member States should not only implement linking rules suggested by the OECD to neutralize double non-taxation, but likewise implement the following rules that cover double taxation.

- Regarding the primary rule: *“The payments are deductible to the extent that such payments are not exempt in hands of the recipient”*.
- Regarding the defensive rule: *“The payments are exempt to the extent that such payments are not deductible in the hands of the payer”*.

By combining OECD linking rules with the rules suggested above, Member States respect fiscal coherence, because the income from a cross-border transaction is only taxed once. Furthermore, this outcome can be

¹¹⁷ AG Kokott (n 115) para 51.

¹¹⁸ Helminen (n 87) 336.

rationalized on theoretical as well as practical grounds.¹¹⁹ Firstly, on a theoretical level, eliminating both situations of double taxation and double non-taxation avoids the rise of distortion and, thus, creates economic efficiency. Indeed, the decision of economic agents to invest abroad or in their home country remains unaffected, because cross-border transactions are neither taxed more heavily nor less onerous than domestic transactions. Secondly, from a practical perspective, double taxation can result in a very high fiscal burden which discourages cross-border investments. Conversely, double non-taxation creates an incentive for taxpayers to invest in foreign jurisdictions and to erode the tax base of their home State.

Based on the above, one would expect that any discrimination resulting from the application of linking rules can be justified by fiscal coherence. Whether these rules should, therefore, be considered enforceable in the light of EU law, depends on the evaluation of the final stage of the ECJ analytical framework which encompasses the proportionality test.

Proportionality principle

As a final step, the ECJ considers whether domestic rules are not disproportionate in achieving their goal. This so-called “proportionality” principle can be divided into two sub-tests. Firstly, it implies that domestic legislation breaching EU law does not go beyond what is necessary to obtain its objective. Secondly, it requires that a violation of the four freedoms is appropriate to achieve its aim.¹²⁰

In the light of the ECJ judgement in the *Papillon* case,¹²¹ it remains questionable whether the ECJ would perceive the current version of OECD linking rules “not to go beyond what is necessary” to attain their objective of fiscal coherence and, thus, pass the first proportionality sub-test. The *Papillon* case concerned the French tax consolidation regime which provided for the neutrality of intra-group transactions. The regime only applied to French companies and was not applicable to subsidiaries of the parent which were indirectly held through a non-resident subsidiary. According to the Court, the French regime achieved fiscal coherence, because a direct link existed between tax advantages of the consolidation regime and the neutralization of intra-group transactions, which avoided a double deduction of losses at the level of resident

¹¹⁹ Reuven Avi-Yonah, ‘Tax Competition, Tax Arbitrage and the International Tax Regime’ (2007) 61(4) Bulletin for International Tax Regime 130, 134.

¹²⁰ Case C-55/94 *Gebhard* [1995] ECR I-4165, para 37.

¹²¹ Case C-418/07 *Papillon* [2008] ECR I-8947.

companies subjected to the consolidation regime.¹²² However, the subsidiaries of the non-resident subsidiary were unable to prove that no risk of double use of losses existed in their particular case. Therefore, the Court argued that the French legislation, which did not provide the companies involved the opportunity to provide proof to the contrary, went beyond what was necessary to attain its aim of fiscal coherence, and was thus perceived disproportionate.¹²³

Following this judgement, Member States implementing OECD linking rules will have to afford the taxpayer, whose tax benefit is denied, the opportunity to prove that no divergence in the qualification of the hybrid financial instrument emerges. Otherwise, the Court may conclude that, due to their automatic application, OECD linking rules go beyond what is necessary to attain fiscal coherence. Moreover, considering the effectiveness principle, the right to provide counterproof cannot be excessively burdensome, “so as to render virtually impossible or excessively difficult the exercise of rights conferred by Community law”.¹²⁴ The question arises as to whether the burden of proof of the tax treatment in another State does not impose an excessive onus to the taxpayer that could constitute a breach of the effectiveness principle. Arguably, such an administrative constrain can be condoned since the Mutual Assistance Directive provides the required information regarding the tax treatment of a financial instruments in other Member States.¹²⁵ Indeed, in its previous case law, the ECJ has already considered the application of the Mutual Assistance Directive in determining whether an excessive administrative burden can serve as a potential justification.¹²⁶

Regarding the appropriateness of OECD linking rules in achieving fiscal coherence, it is important to note that their scope does not cover all situations of hybrid mismatches. Indeed, while the qualification of payments between related parties (and unrelated entities that are party of a structured arrangement) are aligned under OECD linking rules, double non-taxation can still arise regarding payments between regular unrelated parties. Due to the different treatment between related and unrelated parties, OECD linking rules are not in every respect adequate to achieve their objective.¹²⁷ Indeed, the second ECJ proportionality sub-test will only be met if situations of double non-taxation are abolished entirely. Hence, although there are practical reasons to rationalize the

¹²² *ibid* para 51.

¹²³ *ibid* para 61.

¹²⁴ AG Kokott (n 115) para 73.

¹²⁵ Council Directive 2011/16/EU on administrative cooperation in the field of taxation [2011] OJ L64.

¹²⁶ Bammens (n 63) 91.

¹²⁷ Christian Kahlenberg, ‘Hybrid Mismatch Arrangements – A Myth or a Problem That Still Exists?’ (2016) 8(1) *World Tax Journal* 37, 74.

limited scope of application (for example, the gathering of information regarding tax classification), Member States should extend the scope of the OECD proposals to include unrelated parties.

CONCLUSION

The research question addressed in this paper is the following: “Are OECD linking rules proposed in Action 2 suitable to address tax arbitrage enforceable in the light of EU law?”

To answer this question, the following topics have been examined above: the issue of tax arbitrage, BEPS Action 2, and the analytical framework adopted by the ECJ.

The use of hybrid financial instruments in cross border-transactions may give rise to a double tax benefit due to the lack of harmonization in tax classification systems currently applicable among jurisdictions. This issue of tax arbitrage negatively affects tax revenue, competition, economic efficiency, transparency and fairness. To cope with the externalities resulting from tax arbitrage, the OECD proposes the implementation of linking rules in BEPS Action 2. These rules make the qualification of a particular payment conditional on its qualification in the other State in order to ensure that cross-border hybrid instruments are always subject to tax.

The ECJ adopted an analytical framework which encompasses several steps to assess the compatibility of domestic law with EU law. Following these steps, one would expect that linking rules suggested by the OECD as a means to address tax arbitrage are enforceable in the light of EU law, provided that the Member States implementing these rules complement them with additional conditions. Firstly, by modifying linking rules domestically in the way that they not only eliminate double non-taxation but also double taxation, Member States can fully respect fiscal coherence. Hence, any potential discrimination resulting from the application of linking rules can be justified by an overriding reason in the public interest. Secondly, Member States should afford the taxpayer, whose tax benefit is denied, the opportunity to prove that no divergence in the qualification of the hybrid financial instrument emerges. Otherwise, linking rules would violate the proportionality principle by going beyond what is necessary to attain fiscal coherence. Thirdly, the proportionality principle likewise requires that linking rules are suitable to achieve their objective. Since fiscal coherence requires that double non-taxation is entirely abolished, Member States have to extend the scope of the OECD proposals to include unrelated parties.

In conclusion, under the right conditions, OECD linking rules successfully address tax arbitrage. However, only time will tell whether Member States want to implement such conditions, and whether they are keen on implementing linking rules in the first place.