European Union

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Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1

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In this two-part article, the author addresses the application of EU tax directives on hybrid financial instruments. In Part 1, the applicability of the Parent-Subsidiary Directive and the Interest and Royalties Directive is analysed. In Part 2, unilateral measures of Member States to combat cross-border arbitrage are discussed. Moreover, Part 2 contains an analysis of the holding requirements under the directives and the application of the EU Arbitration Convention.

1. Background, Aim and Structure

Financial innovation has increased significantly in the past 30 years. The international financial market has also changed dramatically and is likely to continue to do so. A vast number of financial products have been developed for the use of financial institutions and companies as a result of this innovation.[1] The development, which began in the 1980s, has been described as a "mutation" of financial products.[2] Traditionally, European companies have been rather conservative in their use of financing sources, preferring the use of straight debt from banks and the issuance of share capital as sources of financing.[3] Hybrid financial instruments (HFIs) were used as early as the 16th century by the first English companies.[4] However, HFIs cannot be defined in general.[5] It can be said that an HFI is a financial instrument that has economic characteristics that are inconsistent, in whole or in part, with the classification implied by its legal form.[6] Such an instrument may possess characteristics that are consistent with more than one tax classification (in more than one jurisdiction) or that are not clearly consistent with any classification.[7] Traditionally, the term is used for an array of financial instruments that contain debt and equity features.[8] HFIs are used primarily to provide certain desired characteristics not present in purer forms of debt or equity.[9] HFIs may either be debt instruments combined with equity features or equity instruments with debt features.[10] For tax law purposes, no general international definition exists – or is needed, for that matter.

HFIs really took off on the European markets with financial institutions at the time of the introduction of the euro, and this market has been growing ever since.[11]

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1. See H. Schlunk, "Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?", *Texas Law Review* 80 (2002), p. 859 et seq. (pp. 861-862), who states that, theoretically, there is no limit to the number of new instruments that can be created from deconstruction and reconstruction of debt and equity instruments. Accordingly, there is no theoretical limit to the number of new instruments that can be created in an attempt to exploit the inconsistency in the tax treatment of corporate debt and equity. In the view of Schlunk, the debt-equity distinction will be eliminated as a result of taxpayers' actions, and since financial innovation is becoming cheaper and cheaper, the distinction will be exploitable by taxpayers to such an extent that their choice of tax treatment will be effectively elective.
2. See D. Hariton, "Distinguishing Between Equity and Debt in the New Financial Environment", 49 *Tax Law Review* 3 (1994), p. 499 et seq.; R. Wood, "The Taxation of Debt, Equity, and Hybrid Arrangements", 47 *Canadian Tax Journal* 1 (1999), p. 49 et seq.
3. See SEC(2001) 1667 and Rapport fra Børsmæglerforeningen, *Nye skridt på det danske obligationsmarked* (1999), p. 17.
4. See Wood, note 2.
5. See H. Eber-Huber, *Hybrid Financing* (Amsterdam: IBFD Publications BV, 1996), p. 8.
6. See J.A. Duncan, "Tax treatment of hybrid financial instruments in cross-border transactions", IFA *Cahiers de droit fiscal international*, Vol. LXXXVa (The Hague: Kluwer Law International, 2000), p. 22 et seq.
7. Id.
8. See I. Nelken (ed.), *Handbook of Hybrid Instruments* (Chichester: John Wiley & Sons Ltd, 2000); G. Mackenzie, "Taxation as a Driver for Designing Hybrid Securities", JAFRA 1 (2006), p. 31; E. Eberhartinger, "Besteuerung und steuerliche Gestaltung hybrider Finanzierungsinstrumente", in M. Bischoff and E. Eberhartinger (eds.), *Hybride Finanzierungsinstrumente* (Vienna: Linde, 2005), p. 121 et seq.; P. Connors and G. Woll, "Hybrid Instruments – Current Issues", 553 *Practitioners Law Institute/Tax* (2002), p. 175; B. Coyle, *Hybrid Financial Instruments* (Canterbury: Financial World Publishing, 2002), p. 2; Committee of European Banking Supervisors (CEBS), Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA) (2007), p. 6, Eber-Huber, note 5, p. 8; R. McCormick and H. Creamer (eds.), *Hybrid Corporate Securities: International Legal Aspects* (London: Sweet & Maxwell, 1987), p. 2.
9. See Connors and Woll, note 8, p. 175.
10. In the financial sector hybrid financial instruments are defined as debt with equity features. See, for example, Euromoney, *The 2006 Guide to Hybrid Capital* (Brighton: Euromoney Handbooks, 2006); *The Euromoney Hybrid Capital Handbook*, 2007/2008; I. Nelken in Nelken (ed.), *Handbook of Hybrid Financial Instruments* (Chichester: John Wiley & Sons Ltd, 2000), p. xv; CEBS, Report on a qualitative analysis of the characteristics of hybrids in the European Economic Area (EEA) (2007); CEBS, Proposal for a common EU definition of Tier 1 Hybrids (2008); CEBS, Consultation Paper on Implementation Guidelines regarding Hybrid Capital Instruments, CP 27 (22 June 2009).
11. See Euromoney, *The 2006 Guide to Hybrid Capital* (Brighton: Euromoney Handbooks, 2006), p. 2 and A. van der Knaap, "Hybrid Capital – the revolution continues", in *The Euromoney Hybrid Capital Handbook*, 2007/2008, p. 11 et seq.

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However, it has been relatively unusual for non-financial companies to issue such hybrid capital. In 2005 this changed dramatically, resulting in a massive use of HFIs issued by companies outside the financial sector. This change seems to have been triggered by a more uniform approach by rating agencies to assessing the effect of hybrid issuance.[12]

The subject of this article is the tax law implications of HFIs in the EU law context. In this context, intercorporate dividends and interest payments are two of the few areas that have been harmonized within corporate tax law through the Parent-Subsidiary Directive[13] and the Interest and Royalties Directive.[14] Accordingly, these directives are the most important sources of EU tax law with respect to cross-border HFIs, as no specific legislation aimed at such instruments has been introduced. Obviously, HFIs give rise to a number of issues with regard to the Parent-Subsidiary Directive and the Interest and Royalties Directive, as the directives are designed to address tax law issues regarding pure equity and pure debt instruments. These issues are the subject of the analysis in this article. As a consequence of being limited to the Parent-Subsidiary Directive and the Interest and Royalties Directive, the article only deals with HFIs in the context of EU groups of companies within the scope of the directives.

The analysis is carried out with the objective of reviewing the existing contributions in the tax literature regarding HFIs in the context of the EU corporate tax directives. Moreover, the analysis will address questions that have not yet been addressed in the European tax literature.

First, the article analyses whether or not yield from hybrid debt instruments (equity-like debt instruments) may benefit from the Interest and Royalties Directive.

Second, whether or not yield from hybrid equity instruments (debt-like equity instruments) may benefit from the Parent-Subsidiary Directive is examined. The latter question, moreover, includes an analysis of whether or not yield excluded from the scope of the Interest and Royalties Directive should instead benefit from the Parent-Subsidiary Directive. These questions concern HFIs consistently classified as debt or equity instruments in the Member States involved, as well as HFIs that are inconsistently classified due to a domestic reclassification from debt to equity and, consequently, from interest to dividends. This question requires an analysis of the definitions of dividends, equity, interest and debt, as set out in the directives. The analysis is carried out at an overall analytical level, implying that the general applicability of the Parent-Subsidiary Directive and the Interest and Royalties Directive with regard to HFIs is the key topic addressed. As a result of this limitation, actual examples of HFIs are not analysed. If the directives do not apply, double taxation may occur in specific situations.

Third, the article analyses whether classification inconsistencies can arise irrespective of the existence of the directives or whether the Member States are obliged to classify HFIs and the yield from such instruments in a consistent manner under the directives. This question is primarily of interest in the context of the Parent-Subsidiary Directive. Closely linked to this, the article examines whether or not the Parent-Subsidiary Directive allows for the reclassification of dividends as other types of income under domestic law.

Fourth, the question is raised whether or not a Member State is allowed to deny the benefits of the Parent-Subsidiary Directive to combat cross-border tax arbitrage, if the payment is deductible at the level of the company resident in the source state.

Fifth, the article analyses whether or not HFIs that are not considered formal equity and instruments that are reclassified in a Member State can fulfil the holding requirements contained in the directives.

Sixth, the applicability of the Arbitration Convention (90/436/EEC) is analysed with respect to classification inconsistencies. Finally, the article presents general conclusions regarding the above questions.

2. Hybrid Debt Instruments (Equity-Like Debt Instruments)

2.1. The notion of interest and debt under the Interest and Royalties Directive – positive demarcation

Interest payments between associated companies within the European Union may avoid withholding tax (but not income tax in the residence state) according to the Interest and Royalties Directive. In Art. 1(1) of the Interest and Royalties Directive, it is stated that interest payments arising in a Member State shall be relieved from any form of tax in the source state under the condition that the beneficial owner of the interest is a company or a permanent establishment in another Member State belonging to a company in a Member State. It is a requirement under the Interest and Royalties Directive that both the debtor company and the creditor company fall under the definition of a "company of a Member State" (i.e. the test mentioned in the annex to the Interest and Royalties Directive) and are taxable entities resident in a Member State. Another important requirement is that the companies be associated, as defined in Art. 3(1)(b). A company is considered to be associated with another company (1) if it directly owns at least 25% of the capital of the other company, (2) if the other company directly owns at least 25% of the capital of the first company, or (3) if a third company directly owns at least

12. See *The 2006 Guide to Hybrid Capital*, note 11, p. 10; M. Amin, *Hybrid capital – A Simple Introduction* (2006), p. 3, available at http://pwc.blogs.com/mohammed_amin/2006/02/hybrid_capital_.html.
13. Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, as amended by Directive 2003/123/EC.
14. Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States. Amendments to the directive were proposed in COM(2003) 841.

25% of the capital of both the payor company and the receiving company. These general requirements for applying the Interest and Royalties Directive are not analysed. The core of the analysis is payments included within the scope of the Directive.

The Interest and Royalties Directive is more informative than the Parent-Subsidiary Directive in terms of defining the notion of interest; it is defined directly in Art. 2(1)(a) of the Directive, as follows:

> (a) the term "interest" means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payment shall not be regarded as interest.

The background to the interest definition is explained in COM(1998) 67 final (one of the earlier proposals for the Interest and Royalties Directive) at p. 6:

> The term "interest" as used for the purposes of this Directive denotes in general all income from debt-claims of every kind. The definition is based on that used in Article 11 of the 1996 OECD Model Tax Convention on income and on capital, with the exception of income from government securities which is not relevant to this Directive. Penalty charges for late payment do not really constitute income from capital, but are rather a special form of compensation for loss suffered through the debtor's delay in meeting his obligations. These charges are therefore, as in Article 11 of the OECD Model Tax Convention, not regarded as interest for the purposes of this Directive...

It is interesting to note that the notion of interest is intended to be similar to the notion used in the OECD Model Tax Convention (OECD Model). The notion of debt claims also seems broad. The wording refers to debt claims of any kind. Based on this, in the author's opinion, any debt claim that is a debt claim for private law purposes falls under the scope of the Interest and Royalties Directive. Moreover, the notion of interest under the Interest and Royalties Directive also includes certain capital gains as income from debt claims of any kind.[15]

2.2. Exclusion of certain HFIs – negative demarcation

At first glance, the notion of interest in the Interest and Royalties Directive appears to be wide and also includes yield from certain HFIs.[16] However, Art. 2 should be read in conjunction with Art. 4 of the Directive in order to clarify the actual scope of the definition.[17] In Art. 4 of the Interest and Royalties Directive, the source state is given the right to deny the benefits of the Directive with regard to the use of some common types of HFIs. It remains unclear why Member States have been given the option of excluding certain financial instruments from the scope of the Directive rather than generally excluding the instruments from the scope of the Directive. The wording of Art. 4 is as follows:

> *Article 4*
> *Exclusion of payments as interest or royalties*
>
> 1. The source State shall not be obliged to ensure the benefits of this Directive in the following cases:
> (a) payments which are treated as a distribution of profits or as a repayment of capital under the law of the source State;
> (b) payments from debt-claims which carry a right to participate in the debtor's profits;
> (c) payments from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits;
> (d) payments from debt-claims which contain no provision for repayment of the principal amount or where the repayment is due more than 50 years after the date of issue.

The overall policy background for this provision is explained in COM(1998) 67, p. 8, which comments on a previous draft of the Interest and Royalties Directive:

> [...] Member States are permitted to exclude certain payments which may fall under the notion of interest but which actually have the character of distributed profits, income treated as a return of capital or income from hybrid financing. This could arise, for example, under the provisions of a Double Taxation Convention in force between the Member State where the interest arises and the Member State of the beneficial owner or under the law of the Member State where the interest arises.
>
> Interest that has been re-characterized as distributed profits ought to benefit from the provisions of Directive 90/435/EEC provided all other requirements of that Directive are met, in order to avoid double taxation of such profits [...].

Thus, Member States may decide whether the benefits of the Interest and Royalties Directive apply with regard to financial instruments that fall within the scope of Art. 4 of the Directive.[18] The enumeration of excluded financial instruments should be considered exhaustive, in contrast to previous drafts of the Directive.[19] It is uncertain what legal weight should be given to the statement in COM(1998) 67, p. 8, that income from hybrid finance may be excluded from the Interest and Royalties Directive, for example, under the provisions of a tax treaty between the countries or under the law of the Member State where the interest arises. In other words, the 1998 statement seems to rely on the classification under a tax treaty. Such a link is not found in the wording of the final version of the Interest and Royalties Directive. In the author's opinion, as a consequence, the interpretation of the Interest and Royalties Directive should not rely on the statement by the Commission regarding the previous proposal for the Directive.

Turning to the types of payments from instruments that are excluded from the Interest and Royalties Directive by Art. 4 of the Directive, it is evident that payments that are treated as a distribution of profits or as a repayment of capital under the law of the source state may be excluded from the scope of the Interest and Royalties Directive by the Member States under Art. 4(1)(a). This exclusion has a rather wide scope and should include yield from some forms of HFIs, as well as interest subject to thin cap-

15. Government bonds are not covered by the Directive, since Member States are not considered companies that fall under the scope of the Directive; see M. Gusmeroli, "Triangular cases and the Interest and Royalties Directive: untying the Gordian knot? – Part 2", *European Taxation* 2 (2005), p. 39 at p. 44.
16. See M. Distaso and R. Russo, "The EC Interest and Royalties Directive – A Comment", *European Taxation* 4 (2004), p. 149.
17. Id.
18. Id.
19. See D. Weber, "The proposed EC Interest and Royalty Directive", *EC Tax Review* 1 (2000), p. 25.

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italization legislation in the source state that reclassifies interest as dividends.[20]

The effect of Art. 4(1)(a) on domestic thin capitalization provisions that do not result in a reclassification is uncertain, but is not analysed further in this context.[21] Moreover, the exact meaning of the phrase "which are treated" is unclear. It would not be correct to interpret this as meaning that Member States are generally permitted to classify the yield on HFIs as they please.[22] Some Member States have introduced anti-arbitrage provisions reclassifying debt/interest instruments as equity/dividends if the instrument is treated as equity in the state of residence of the recipient of the payment.[23]

Art. 4(1)(a) of the Interest and Royalties Directive also includes the phrase "repayment of capital". In most Member States the repayment of the principal itself should not give rise to tax consequences and is non-deductible. If, however, a Member State decides to levy withholding tax on the repayment of capital, the Interest and Royalties Directive allows for this withholding tax despite the overall purpose of the Directive.

Payments from debt claims that carry a right to participate in the debtor's profits can be excluded from the Interest and Royalties Directive according to Art. 4(1)(b). This potentially excludes some profit-participating loans, participating bonds, jouissance rights and silent partnerships from the scope of the Directive.[24] According to Eberhartinger and Six, this provision, in combination with the Parent-Subsidiary Directive, provides Member States with the possibility of totally excluding jouissance rights and silent partnerships from the directives by treating them as debt under domestic law, which exempts them from the benefits of the Parent-Subsidiary Directive, and then using Art. 4(1)(b) of the Interest and Royalties Directive to exempt them from the benefits of that Directive.[25] The wording of the provision makes reference to "debtor's profits", which, moreover, leads to the exclusion of instruments the interest payments of which are directly connected to the profit of an entity other than the debtor (for example, a subsidiary of the debtor).[26] This covers "exchangeables".[27]

The third exclusion from the notion of interest is interest payments from debt claims that entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits (Art. 4(1)(c) Interest and Royalties Directive). The wording of this provision is ambiguous. According to Distaso and Russo, pursuant to a literal interpretation of the wording of the Directive, this would include interest-bearing loans that provide the creditor with the possibility to convert entitlement to interest into a right to a percentage of the profits of the borrower.[28] However, the reference to the "right to participate in the debtors' profits" rather than to the "debtor's equity" does not automatically include financial instruments granting the right to convert the loan (and, in certain instances, the accrued interest income) into share capital of the borrower (i.e. traditional convertible loans/bonds). The question is whether or not the reference to "the right to interest" means the claim in general and whether the reference to "the right to participate in the debtor's profits" simply is another way to describe participation in the debtor's equity. A literal interpretation of the provision would exclude convertible bonds and warrant bonds from the scope of the Interest and Royalties Directive.[29] Such an interpretation is supported in the tax literature.[30]

Finally, payments from debt claims that contain no provision for repayment of the principal amount, or where the repayment is due more than 50 years after the date of issue, are covered by Art. 4(1)(d). This section also targets HFIs which are, in effect, equity due to a lack of repayment date or an extraordinarily long term of more than 50 years. Super-maturity debt and perpetual debt fall under the scope of this provision.[31]

The Directive does not directly explain the limitations of the scope of Art. 4.[32] It may be said, however, that a restrictive interpretation of the Directive is correct and justifiable because the provisions in Art. 4 of the Directive are meant to be exceptions to the general rule of application of the Directive stipulated in Art. 2. Therefore, a broad interpretation of these exceptions that includes situations that are not explicitly included in the text would frustrate the purpose of the Directive.[33]

As a consequence of this negative demarcation of payments falling within the scope of the Interest and Royalties Directive, the question arises as to whether or not such payments instead fall within the scope of the Parent-Subsidiary Directive. As presented in 3.2.3., it is commonly agreed in the tax literature that payments that are excluded from the scope of the Interest and Royalties Directive under Art. 4(1)(a) should instead fall under the scope of the Parent-Subsidiary Directive.[34] This was also explicitly stated in COM(1998) 67 final regarding the previous draft of the Interest and Royalties Directive. This is not the situation, however, with respect to interest

20. See also, regarding the latter, Distaso and Russo, note 16, p. 150.
21. See Gusmeroli, note 15, p. 44.
22. See, for critical comments, Weber, note 19, p. 26.
23. See 4. regarding these measures.
24. Under Danish case law, yield on profit-participating loans is treated partially as interest and partially as capital gains. See TfS (Journal of Danish Tax Law) 1998.77 LR, TfS 2006.127 LR, TfS 2008.407 SR, TfS 2008.546 SR, SKM 2007.881 SR, SKM 2006.20 SR and SKM 2008.245.
25. See E. Eberhartinger and M. Six, "National Tax Policy, the Directives and Hybrid Finance", in K. Andersson et al. (eds.), *National Tax Policy in Europe* (Berlin: Springer, 2007), p. 225 at p. 228. The authors also published their conclusions in "Taxation of Cross-Border Hybrid Finance: A Legal Analysis", *Intertax* 1 (2009), p. 4 et seq. In the following, reference is only made to the former publication.
26. See Distaso and Russo, note 16, p. 150, and, in support of this, Eberhartinger and Six, note 25, p. 228, footnote 85.
27. See Distaso and Russo, note 16, p. 150
28. Id.
29. See Eberhartinger and Six, note 25, p. 228.
30. See Distaso and Russo, note 16, p. 150 and Eberhartinger and Six, note 25, p. 228.
31. See, in general, regarding such instruments, J. Bundgaard, "Perpetual and super-maturity debt instruments in international tax law", *Derivatives & Financial Instruments* 4 (2008), p. 157 et seq.
32. See Weber, note 19, p. 26 and Distaso and Russo, note 16, p. 150.
33. See Distaso and Russo, note 16.
34. See Eberhartinger and Six, note 25, p. 227 and Distaso and Russo, note 16, p. 150.

payments mentioned under Art. 4(b)-(d). In this regard, Art. 4 of the 1998 proposal only referred to interest "that has been re-characterized as a distribution of profits". In contrast, Art. 4(1)(b), (c) and (d) of the version finally adopted applies to situations where the treatment under the domestic tax law of the source state corresponds to the general definition of interest in Art. 2(1) of the Interest and Royalties Directive,[35] but other features of the instrument imply that the instrument should not be included within the scope of the Interest and Royalties Directive. Accordingly, payments on HFIs falling within the scope of Art. 4(1)(b), (c) or (d) may be subject to double taxation in cases of classification inconsistency between the Member States involved. However, if such payments are, in fact, reclassified as "distributed profits", the same interpretation regarding covert distributions ought to apply to such payments as well. Thus, the Parent-Subsidiary Directive may be said to take precedence over the Interest and Royalties Directive. From a practical perspective it should, however, be noted that the holding thresholds in the two Directives are different and may lead to incongruous results, for instance in the context of a reclassification of an interest payment as a profit distribution.[36] An interest payment between companies associated through a "holding" of at least 10%, but less than 25%, would not qualify for relief under the Interest and Royalties Directive, but would qualify for relief under the Parent-Subsidiary Directive if reclassified as a profit distribution.[37]

Eberhartinger and Six, moreover, raise the question of what would happen if payments that are classified as profit distributions under the tax law of the source state fall within the scope of the Parent-Subsidiary Directive and the source state does not exercise the option in Art. 4(1)(a) of the Interest and Royalties Directive and if these payments fall within the scope of both directives.[38] As regards the possibility of levying withholding tax, the result should be the same even though the payment, in theory, might qualify as interest and as a profit distribution.

In general, the limitations contained in Art. 4 have been questioned in the tax literature. Distaso and Russo have stated that:

> [...] Looking at the cases provided for by Art. 4(1) of the Directive, it seems that the Member States, apart from cases under letter (a), will be allowed to deny the application of the Directive (i.e. the exemption from withholding tax on interest) irrespective of the fact that the payments under debt claims as described under letters (b), (c), (d) are treated as profit distributions in that Member State. Therefore, such payments may still keep their characterization as interest under the laws of the source state but may nonetheless be subject to withholding tax on interest in the same state. Frankly, the rationale behind the denial of the benefits of the Directive is difficult to understand without the reference to a corresponding profit recharacterization or a limitation of the deduction of the interest expense in the source state. A justification may be found by assuming that through the cases mentioned under letters (b), (c), (d), the Directive has granted the source state the possibility of levying withholding tax on interest if the payments under the financial instruments described are still treated as interest in the source state but are characterized as profit distributions in the Member State of the recipient. In other words, the Directive's intention would be to "hit" those instruments that create a tax deduction in the source state and which give rise to an exemption from taxation of the correspondent income received in the residence state (or state of establishment) of the recipient, as such income would be characterized as a profit distribution [...]."[39]

If this interpretation is correct, it is regrettable that a shotgun approach was adopted in the final version of the Directive, also excluding from the scope of the Directive several HFIs existing under international finance practice that are issued due to economic reasons.

In conclusion, although the scope of the Interest and Royalties Directive with respect to HFIs is specifically addressed in Art. 4 of the Interest and Royalties Directive, uncertainty regarding the correct interpretation remains in regard of the applicability of the Directive to certain types of HFIs.

3. Hybrid Equity Instruments (Debt-Like Equity Instruments)

3.1. Dividends and equity – distributions of profit under the Parent-Subsidiary Directive

Dividends paid between Member State companies are covered by the Parent-Subsidiary Directive. The Parent-Subsidiary Directive requires that double taxation be avoided either by exempting the dividends or by granting a tax credit equivalent to the tax paid on the distributed profits. The Parent-Subsidiary Directive contains tax rules regarding the Member State of the company paying the dividends and the Member State of the company receiving the dividends. Dividends not covered by the Directive may be subject to (temporary or permanent) double taxation, since no general obligation to abolish such double taxation exists under EU law (see, for example, *Kerckhaert and Morres*).[40] The Parent-Subsidiary Directive applies to distributions of profits between associated companies from different Member States. The companies involved must be subject to corporate tax in their respective Member States. Both the payer and the recipient must be in a legal form listed in the annex to the Directive. The profit distributions must be made to associated companies with a direct holding of 10% in the capital of the companies paying the dividends.

As debt-equity hybrids by nature include debt and equity characteristics, the instrument may wholly or partially be classified as equity and, consequently, the yield on the instrument as a dividend. As the Parent-Subsidiary Directive, in fact, applies to a yield on equity, it is important

35. See Eberhartinger and Six, note 25, p. 228.
36. Report from the Commission to the Council in accordance with Article 8 of Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, COM(2009) 179 final, p. 9.
37. Id.
38. Eberhartinger and Six, note 25, p. 228.
39. Distaso and Russo, note 16. See also, to this effect, Eberhartinger and Six, note 25, p. 229.
40. ECJ, 14 November 2006, Case C-513/04, *Mark Kerckhaert, Bernadette Morres v. Belgian State*, Para. 22. It should also be noted that the Lisbon Treaty has repealed Art. 293 of the EC Treaty.

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to analyse the notion of "distributions" under the Directive to determine whether or not a hybrid instrument falls within the scope of the Directive. It should, however, be noted that the European Court of Justice (ECJ) has not yet made a ruling on the application of the Parent-Subsidiary Directive to yield on HFIs. The following detailed analysis of the notion of a distribution of profits is, therefore, necessary in order to carry out the subsequent analysis of the applicability of the Parent-Subsidiary Directive with respect to HFIs.

3.1.1. Absence of definition makes way for an (almost) autonomous EU law meaning

The general requirements that need to be met to invoke the Parent-Subsidiary Directive are not analysed in the following discussion.[41] The core of the analysis is payments included within the scope of the Directive, which encompasses "distributions of profits" and "profits which a subsidiary distributes".[42] These terms are not defined in the Directive and, therefore, need to be analysed in general and, more specifically, with respect to HFIs. A previous proposal for the Parent-Subsidiary Directive did contain a definition of the term "dividend",[43] but a definition of the notion of a "distributions of profits" was absent from the Directive as finally adopted.[44] This previous definition clearly does not directly influence the existing definition in the Parent-Subsidiary Directive.

The absence of a definition of "distributions of profits" in the Parent-Subsidiary Directive has led some commentators to conclude that the term must be given an autonomous meaning that is independent of domestic law and tax treaty definitions. Terra and Wattel agree that the Directive definition should not contain a reference to domestic law, as is the case in tax treaties.[45] Thus, it is argued by those authors that EU law harmonization requires an autonomous concept that is different from domestic law or bilateral treaty concepts.[46] The authors submit:

> [...] that the term "distributions" is a Community law expression, to be interpreted autonomously by the ECJ and by the national tax courts in the light of object and purpose of the Directive (and, where appropriate, also in the light of the object and purpose of the EC Treaty, notably the Freedoms of establishment and capital movement) [...].[47]

Moreover, it is stated by Terra and Wattel that the application of tax treaties presupposes the same classification in both states, which cannot be said with regard to EU law, since harmonization would otherwise be pointless.[48] Finally, ECJ case law regarding the interpretation of other terms of the Parent-Subsidiary Directive is said to support the view that the concepts in the Directive are autonomous.[49] Brokelind also supports the idea that the concept of distributed profits is an autonomous EU law concept.[50] The author, however, states that there is no agreement in the doctrine on its extent. Further, there is no ECJ or other national court case law regarding the applicability of the Parent-Subsidiary Directive with respect to HFIs.[51]

The above line of reasoning was indirectly supported by Advocate General Mischo in his Opinion in the *Lankhorst-Hohorst* case[52] with regard to another expression of the Parent-Subsidiary Directive, namely "tax". The Advocate General stated in Para. 102 et seq. of his Opinion that Art. 5 of the Parent-Subsidiary Directive is not limited in its scope to specific taxes and that the qualification of a tax is autonomous from domestic law.[53]

Despite the agreement on the autonomy of the notion of a distribution of profits, commentators have been reluctant to recognize an autonomous understanding that is totally independent from domestic law meanings, since the Directive, after all, deals with the taxation of domestic law distributions of different Member States.[54] As stated by Helminen, an interpretation that partly depends on each state's domestic law is in line with the objective of the Parent-Subsidiary Directive expressed in its preamble, which, inter alia, requires that economic double taxation be avoided in the same situations as

41. The literature on the general scope of the Parent-Subsidiary Directive is vast.
42. Arts. 1, 4 and 5 of Parent-Subsidiary Directive use the expression with the variations mentioned.
43. See Proposal for a Directive of the Council Concerning the Harmonization of Systems of Company Taxation and of Withholding Taxes on Dividends, Submitted to the Council by the Commission, 23 July 1975, COM(75) 392 final, withdrawn by decision of the Commission of 18 April 1990. According to Art. 2(1) of the proposed directive, the term was defined as: "[...] that part of the profits of any corporation of a Member State, other than a corporation in liquidation, distributed by it by virtue of a proper decision of its competent authorities and divided among its members in proportion to their rights as members of the corporation; distributions of bonus shares are not regarded as dividend within the meaning of the present directive [...]".
44. Council Directive 77/91/EEC (the Second Company Law Directive) of 13 December 1977, as amended, defines the term "distribution" in Art. 5(1)(d) as a distribution of profits or payment of interest to the shareholders based on their holdings of shares in the company. See M. Helminen, *The Dividend Concept in International Tax Law* (The Hague: Kluwer Law International, 1999), p. 72, wherein the author states that the company law Capital Directive cannot be used to interpret the concept of profit distribution under the Parent-Subsidiary Directive.
45. See B.J.M. Terra and P.J. Wattel, *European Tax Law* (5th ed.) (The Hague: Kluwer Law International, 2008), p. 499. See also Art. 10 of the OECD Model, and Para. 23 of the OECD Commentary to this article.
46. See supportive, for example, Helminen, note 44, p. 73; P. Farmer and R. Lyal, *EC Tax Law* (Oxford: Oxford University Press, 1994), p. 272 et seq.; C. Brokelind, "Swedish Supreme Administrative Court Rejects Reference to ECJ Regarding Application of EC Parent-Subsidiary Directive", *European Taxation* 8 (2005), p. 327 et seq. Helminen also discussed the subject in "Dividend equivalent benefits and the concept of profit distribution of the EC Parent-Subsidiary Directive", *EC Tax Review* 3 (2000), p. 161. Reference is only made to the book version in the following, but the same conclusions are presented in the article with respect to HFIs.
47. Terra and Wattel, note 45, p. 499.
48. See Brokelind, note 46, p. 327 et seq.
49. Id.
50. Id.
51. See also Brokelind, note 46, p. 327 et seq. analysing the application of the Parent-Subsidiary Directive regarding profit-participating loans. The author regrets that the Swedish Supreme Administrative Court refused to refer a case to the ECJ regarding the application of the Parent-Subsidiary Directive to income from profit-participating loans.
52. ECJ, 12 December 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*.
53. See, to this effect, ECJ, 4 October 2001, Case C-294/99, *Athinaïki Zythopiïa AE v. Elleniko Dimosio*, Paras. 26 and 27.
54. See Helminen, note 44, p. 73 and L. Hinnekens, "Compatibility of bilateral tax treaties with European Community law – application of the rules", *EC Tax Review* 4 (1995), p. 219, giving weight to the fact that Art. 10 of the OECD Model refers to domestic law. See also Farmer and Lyal, note 46, p. 272 et seq. stating that the interpretation should not be left *wholly* to domestic law.

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under domestic law.[55] On the other hand, an interpretation based solely on domestic law is not possible either, because the concept of a "distribution of profits" may be given a different meaning in different Member States.[56] Farmer and Lyal argue that it would be preferable for the ECJ to lay down certain criteria that may be applied by national authorities within the framework of their national systems of company taxation.[57]

3.1.2. Actual contents of the notion of a "distribution of profits"

3.1.2.1. General interpretation in the tax literature

If it is acknowledged that the expression "distribution of profits" is a (partially) autonomous EU law expression, the next challenge is to clarify the exact contents of the expression. Given the uncertainty regarding this notion, it is questionable whether or not this would be fruitful. Nevertheless, the following is an attempt to undertake this task.

Compared to the previous proposals of the Parent-Subsidiary Directive, the notion of a "distribution of profits" should probably be understood as being broader than the term "dividends".[58] The arguments in favour of such a broad interpretation are: (1) that the term "dividends" could have been used if a narrow scope was intended; and (2) that a broad meaning is in line with the objective of the Directive to avoid economic double taxation of profits received by parent companies from their subsidiaries.[59]

The point of view regarding an autonomous understanding of the notion of a distribution of profits outlined in 3.1.1. has led some authors to argue that the expression should be interpreted in a substantive and economic manner.[60] Terra and Wattel submit that the concept of profit distributions should be interpreted not formally but substantively, covering any value shift to the parent company at the expense of the capital of the subsidiary in connection with the parent's provision of equity capital to the subsidiary, including constructive equity capital.[61]

Based on a teleological interpretation, it seems correct to include payments that are, in fact, treated as dividends in the source state or that are, in substance, dividends within the scope of the Directive. Helminen concludes that the scope of the notion of dividends covers any kind of transfer of benefits from a qualifying corporation to another qualifying corporation for no equivalent value or benefit in exchange.[62] That author finds that this definition should apply to the extent that an item is not expressly excluded from the Parent-Subsidiary Directive and to the extent that the transfer is such that, in principle, it could be subject to economic double taxation.[63] According to Terra and Wattel, the concept of a profit distribution also encompasses payments labelled as "interest" on formally designated loans that are not expected to be repaid by the subsidiary, through which the parent company, in fact, fully participates in the entrepreneurial risks of its subsidiary. Such interest must, therefore, be recharacterized as equity for tax purposes.[64] In *Athinaïki Zythopoiïa* the ECJ stated that Art. 5 is not limited in its scope to specific taxes and that the classification of a tax is autonomous from domestic law.[65]

In the *Lankhorst-Hohorst* case the Advocate General found that the corporate tax burden in Germany of Lankhorst-Hohorst, resulting from the recharacterization of the interest as a dividend, should be regarded as a dividend withholding tax within the meaning of the Parent-Subsidiary Directive and, therefore, prohibited.[66]

There seems to be little direct support in the Parent-Subsidiary Directive for the suggested economic-substance interpretation of the term "distributions of profits". Moreover, it should be pointed out that although it is plausible that the Parent-Subsidiary Directive applies to yield on HFIs, it is problematic to set out criteria for the interpretation of the Directive that depend on the economic nature of a financial instrument. One could question where the authority for such an interpretation comes from and which economic criteria should be applied in this respect. Such an interpretation further gives rise to the question as to which economic content should be given preference. Should the statement be understood as a reference to a legal substance-over-form analysis or, in fact, as a reference to real economic terms and – if so – which criteria apply? Thus, it is well-known that an HFI may be classified differently for accounting purposes, rating purposes, legal purposes, etc.[67] The application of such a method of interpretation seems to presuppose a uniform set of economic criteria used to classify actual HFIs. To the author's knowledge such a uniform set of criteria does not exist. This would ultimately leave it up to the ECJ to assess the true economic nature of HFIs, which would hardly result in increased certainty with regard to the classification of cross-border payments. Legal certainty may suffer as a consequence of

55. See Helminen, note 44, p. 73.
56. Id., p. 74.
57. See Farmer and Lyal, note 46, p. 272.
58. The explanatory memorandum COM(69) 6 final uses the term "dividends". See Helminen, note 44, pp. 74 and 266, for a similar statement. The author concludes that the term "distribution of profits", in general, is understood to have a broader meaning than the term dividends and that this should also apply for the Parent-Subsidiary Directive. See, moreover, G. Maisto, "The 2003 Amendments to the EC Parent-Subsidiary Directive: What's next?", *EC Tax Review* 4 (2004), p. 177, F.C. de Hosson, "The Parent-Subsidiary Directive", *Intertax* 10 (1990), p. 433 and R.A. Sommerhalder, "Approaches to Thin Capitalization", *European Taxation* 3 (1996), p. 93 et seq. See also Eberhartinger and Six, note 25, p. 221 for the same conclusion.
59. See Helminen, note 44, p. 74.
60. See, for example, Terra and Wattel, note 45, p. 506, wherein they conclude that the Court adheres to a substantive, economic and independent Community law interpretation. Moreover, the authors state that the name of the instrument in question is immaterial.
61. See Terra and Wattel, note 45, pp. 498 et seq.
62. See Helminen, note 44, p. 74.
63. Eberhartinger and Six, note 26, p. 218 support this definition.
64. See Terra and Wattel, note 45, p. 498 et seq.
65. See *Athinaïki Zythopoiïa*, note 53, Paras. 26 and 27.
66. See *Lankhorst-Hohorst*, note 52, and ECJ, Advocate General Mischo's Opinion, 26 September 2002, Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, Paras. 102 et seq. See Terra and Wattel, note 45, p. 499.
67. See, for example, *The Euromoney Hybrid Capital Handbook*, 2007/08, note 11 and G. Cottani and M. Liebentritt, "Tier 1 Capital Instruments: Regulatory and Tax Issues", *Derivatives & Financial Instruments* 3 (2008), p. 62 et seq.

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such an interpretation if the economic criteria to be relied on in this important legal assessment are not clarified. Accordingly, it is recommended that specific criteria be developed if the economic-substance line of thinking is endorsed. In line with ECJ case law on the concept of a "distribution of profits", this appears to equal income from shares (see 3.1.2.2.). A distribution of profits seems to further require that the underlying instrument be considered an equity instrument under the Directive.[68] However, the Directive also does not contain a definition of "equity".

In the specific context of HFIs, it is fair to say that the limits of the notion of a distribution of profits will be tested. Given the nature of HFIs, it is obvious that classification inconsistencies may occur amongst Member States. Based on the above argument, the classification issues under the Parent-Subsidiary Directive should depend solely on an autonomous definition of distributions.

Some authors seem to reduce the autonomy theory to a *de lege ferenda* point of view. This is illustrated by Terra and Wattel's statement that it would be desirable if a cross-border distribution of profits were to be regarded as such by the tax authorities on both sides of the border.[69] In referring to Para. 23 of the Commentary to Art. 10 of the OECD Model, they conclude that it does not appear to be possible to work out a definition of the concept of dividends that would be independent from domestic law; moreover, they indicate that there seem to be limits regarding the autonomy of the expression "distributions of profits".

In the absence of a definition in the Directive itself, a reference to Art. 10 of the OECD Model is necessary to develop a commonly agreed notion of what the Parent-Subsidiary Directive means by "distributions of profits".[70] Based on this link, it has been stated that debt claims that include participation in the profits of the issuing company and interest on convertible bonds do not fall under the Parent-Subsidiary Directive.[71] However, there is no evidence in favour of such a link between the relevant sources of international tax law, reducing the value of a reference to Art. 10 of the OECD Model.

The autonomy interpretation is widely accepted among commentators, albeit to varying degrees. Although autonomy is the starting point, this is moderated by an allowance for national deviations with respect to the content of the notion of dividends. Clear guidelines are, however, still absent, leaving the playing field for European companies somewhat blurry with respect to issuing and investing in HFIs.

3.1.2.2. *Interpretation of the Parent-Subsidiary Directive by the ECJ*

The ECJ has yet to interpret the notion of "distributions of profits" directly. However, the concept has been interpreted indirectly in cases regarding the notion of "withholding tax".[72] In Para. 38 of *Océ van der Grinten* it was submitted to the Court that the concept of "profits" is not limited to cash dividends and can include all other forms of income from shares. In the case in question, the ECJ, however, concluded that the concept of dividends did not include tax credits, because a tax credit does not constitute "income from shares".[73]

It is not evident that the reference by the ECJ to "income from shares" also includes income from HFIs in fact considered equity instruments from an economic perspective and/or a domestic law perspective. A vague indication of the ECJ's view on this appears in Para. 23 of *Epson Europe*, where the ECJ interpreted the term "withholding tax" but also referred to the taxable amount as "income from shares". Of specific interest is the Opinion of Advocate General Cosmas, wherein it was stated that:

> 48. From the wording alone of the exemption introduced by Article 5(4) of the Directive it can be noted that the Community legislature refers to "profits" and "withholding tax", not income tax, tax on profits or corporation tax, nor does it use any other similar expression which would lead to a strict interpretation of that provision, as Epson rightly points out in point 25 of its written observations. In my view, this means that all withholding taxes are subject to the prohibition laid down in the Directive, whatever the name or nature of the tax levied on distributed profits. In other words, "withholding tax" cannot be interpreted as being confined to the taxes listed by name in Article 2, since it applies to all taxes levied in the Member State of the subsidiary on distributed profits (dividends).[74] (footnotes omitted)

It seems correct to conclude, in line with the Advocate General, that absent support for a strict interpretation any withholding tax is covered by the prohibition on withholding tax laid down in the Parent-Subsidiary Directive. It is, however, uncertain whether the same line of reasoning can be applied regarding the notion of "distributions of profits". In both situations it is a matter of ensuring that economic and juridical double taxation do not occur regarding intercorporate distributions within the European Union. Thus, it could be argued that any tax and any "distribution" is covered by the Parent-Subsidiary Directive, including yield from HFIs that are equity-like and thus produce dividend-like yield if considered equity/dividends in the source state. However, the issue has not, to date, been addressed directly by the ECJ. Section 3.2. considers this issue in detail.

3.1.2.3. *Different meaning in Arts. 4 and 5 of the Parent-Subsidiary Directive?*

Art. 4(1) of the Parent-Subsidiary Directive stipulates that the country of residence of the parent company should not tax distributed profits received by a parent

68. See, in general, Helminen, note 44, p. 145.
69. See Terra and Wattel, note 45, p. 499.
70. See O. Thömmes and E. Fuks, *EC Corporate Tax Law* (Amsterdam: IBFD, loose-leaf), p. 12 regarding Sec. 6.1.
71. Id., p. 12 regarding Sec. 6.1., referring to Para. 24 of the Commentary on Art. 10 of the OECD Model.
72. See, for example, *Athinaïki Zythopiïa*, note 53, where the ECJ stated that Art. 5 of the Parent-Subsidiary Directive is not limited in its scope to specific taxes and that the classification of a tax is autonomous from national law.
73. ECJ, 25 September 2003, Case C-58/01, *Océ Van der Grinten NV v. Commissioners of Inland Revenue*, Para. 58.
74. ECJ, Advocate General Cosmas's Opinion, 17 February 2000, Case C-375/98, *Ministério Público and Fazenda Pública v. Epson Europe BV*, Para. 48.

company by virtue of the association of the parent company with its subsidiary (inbound payments). Art. 5 stipulates that profits that a subsidiary distributes to its parent company shall be exempt from withholding tax (outbound payments). As is evident, there is a slight difference in the wording of the two provisions. This has led some commentators to discuss whether or not the requirements under the two provisions are different. There are no official statements indicating that such a difference was intended by the Commission.

The difference in the wording was pointed out by Farmer and Lyal, who state that this reflects a difference in perspective between the two provisions.[75] Regarding Art. 5, Farmer and Lyal apparently favour an expansive interpretation that would include all post-tax profits that are treated, in substance, as distributions to the parent company by the source state.[76] Regarding Art. 4, Farmer and Lyal[77] and Vanistendael[78] suggest that the treatment in the hands of the parent company could be marginally different, as only payments received by virtue of its association with the subsidiary are included within the scope of Art. 4 of the Directive.[79] In contrast, the IBFD Survey concludes that there is no evidence to support the argument that the omission reflects any substantive difference in meaning.[80]

If the scope of Art. 5 is broader than the scope of Art. 4, it could be argued, in the context of HFIs, that it is more likely that the source state will exempt payments on HFIs from withholding tax than it is that the parent state will provide for double taxation relief on the payments received from such instruments. However, this issue has yet to be decided upon by the ECJ, and the author tends to favour the interpretation that there is no evidence supporting a substantive difference in meaning of the provisions.

3.2. Analysis of the scope of the Parent-Subsidiary Directive with respect to yield on hybrid financial instruments

3.2.1. General observations

To date, the application of the Parent-Subsidiary Directive with respect to yield on HFIs has only been analysed in theory. Moreover, most in-depth studies that address this question are, in fact, carried out within another area, namely reclassified interest payments based on domestic thin capitalization legislation. Obviously, these analyses are relevant also in the context of HFIs, where the underlying question of the application of the Parent-Subsidiary Directive to payments classified differently in different Member States is identical.

This section will first deal with the methodology that should be applied in order for yield on HFIs to be included within the scope of the Parent-Subsidiary Directive. This is followed by a discussion on the reclassification of interest payments and the general applicability of the Parent-Subsidiary Directive on HFI yield. The section then moves on to the questions of (1) whether payments excluded from the scope of the Interest and Royalties Directive fall within the scope of the Parent-Subsidiary Directive, (2) whether the Parent-Subsidiary Directive allows for classification inconsistencies at all; and (3) whether the Parent-Subsidiary Directive prevents Member States from reclassifying dividend (equity) as interest (debt).

3.2.2. The legal basis for an expansive and teleological interpretation

As has been presented, the precise demarcation of the notion of "distributions of profits" is uncertain. This may affect HFIs that do not directly fall within the scope of the Parent-Subsidiary Directive and thus an expansive and teleological interpretation should be relied on in order to benefit from the Parent-Subsidiary Directive. The following is an analysis of whether or not it is expected that the ECJ will apply such a method or a strict literal interpretation.

If the yield from HFIs is to be covered by the Directive, this requires not only a broad interpretation but also a teleological line of reasoning that gives weight to fulfilling the objective of the Directive. Such an approach seems to be generally endorsed by the ECJ.[81] As a general rule the ECJ has stated that an interpretation of directives should include the object and purpose of the directives.[82]

As pointed out by Peeters and Van de Vijver, an analysis of previous decisions regarding the Parent-Subsidiary Directive reveals a hierarchy in the interpretation methods.[83] Previous case law may be seen as setting out a two-stage approach. First a literal approach is applied and then, if the literal approach leaves room for further interpretation, a teleological interpretation follows.[84] In light of this, the ECJ's decision in *Les Vergers du Vieux Tauves SA* is not surprising, since a literal interpretation left no room for a teleological approach.[85] Peeters and Van de

75. See Farmer and Lyal, note 46, p. 271.
76. Id.
77. Id.
78. See F. Vanistendael, "The implementation of the Parent/Subsidiary Directive in the EC. Comments on some unresolved questions", *Tax Notes International* 12 (1992), pp. 599-619.
79. See, moreover, de Hosson, note 58, p. 10 and Maisto, note 58, p. 16.
80. See W.F.G. Wijnen, *Survey of the Implementation of the EC Corporate Tax Directives* (Amsterdam: IBFD, 1995), p. 363.
81. See, for example, U. Neergaard and R. Nielsen, *EU-ret* (Copenhagen, Thomson Reuters, 2009), p. 116 et seq.
82. See, for example, ECJ, Case C-131/97, *Annalisa Carbonari e.a. contre Università degli studi di Bologna, Ministero della Sanità, Ministero dell'Università e della Ricerca Scientifica, Ministero del Tesoro*, Para. 48; Case C-106/89, 13 November 1990, *Marleasing SA v. La Comercial Internacional de Alimentacion SA*, Para. 8; and Case C-334/92, 16 December 1993, *Teodoro Wagner Miret v. Fondo de Garantía Salarial*, Para. 20.
83. See B. Peeters and A. van de Vijver, "ECJ Rules on Compatibility of Belgian Participation Exemption Regime with EC Parent-Subsidiary Directive", *EC Tax Review* 4 (2009), p. 146 at p. 149.
84. Id. and, for example, ECJ, Case C-375/98, *Ministério Público and Fazenda Pública v Epson Europe BV*, Para. 22 et seq. combining the wording and the objective of the Parent-Subsidiary Directive.
85. Advocate General Sharpston's Opinion reached the opposite conclusion, considering the usufruct a holding in the capital based on the overall scheme and objective of the Parent-Subsidiary Directive. See ECJ, Advocate General Sharpston's Opinion, 3 July 2008, Case C-48/07, *SPF Finances v. Les Vergers du Vieux Tauves SA*, Para. 58 et seq.

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Vijver find that a literal interpretation of the usufruct in question in that case as a right in rem would open the door to a teleological interpretation, while still remaining within the wording of the Directive.[86]

As submitted in 5., the ECJ decision in *Les Vergers du Vieux Tauves SA* may affect the tax classification of HFIs that are, in substance, considered equity, since such HFIs also do not (similar to usufruct) reflect formal equity of a company. Accordingly, a literal interpretation of the Parent-Subsidiary Directive cannot result in HFIs being considered share capital if they are not formally considered to be so. However, there is one important difference between the situation of the usufruct in *Les Vergers du Vieux Tauves SA* and the situation of HFIs. In most cases where HFIs are used, a shareholder relationship is already established, and the question is simply whether or not the HFI in place can increase the holding in the capital above the required holding percentage. Based on this, it is submitted that a literal interpretation of the Parent-Subsidiary Directive does not preclude yield on HFIs from being subject to the benefits of the Directive. Such an interpretation is also in line with the requirement set forth by the ECJ, namely that the Parent-Subsidiary Directive apply to yield from shares.

Turning to the overall objective of the Parent-Subsidiary Directive, this is expressed in Para. 3 of the Preamble, which can be interpreted as including the traditional multi-tier taxation of corporate profits, as well as the avoidance of "asymmetrical" tax treatment of income in two different Member States leading to double taxation.[87] If the application of the Parent-Subsidiary Directive depends on a domestic law classification of HFIs, this objective cannot be achieved. The statement in Para. 3 could, however, be seen as an introductory remark leading to the specific aims of the Directive presented in Paras. 4 and 5 of the Preamble.

Based on the above, there are solid arguments in favour of eliminating double taxation in all scenarios where such double taxation occurs. This would be in line with the overall objective of the Parent-Subsidiary Directive even though HFIs are not explicitly covered by the Directive, and it would also be in line with the ECJ's interpretation in previous case law.

3.2.3. Application of the Parent-Subsidiary Directive to reclassified interest payments

The tax literature has put much emphasis on whether or not the Parent-Subsidiary Directive is applicable in situations regarding thin capitalization and covert distributions.[88] There is also support within this debate for the applicability of the Parent-Subsidiary Directive with respect to yield from HFIs.

Some authors have stated that interpretative assistance in this context may be derived from the term " distribution of profits" in the 1998 proposal for the Interest and Royalties Directive.[89] Under Art. 4 of the proposed directive, certain situations were enumerated where the source state was not obliged to grant Directive benefits. Based on a reading of that provision and the Commission's explanatory memorandum in COM(1998) 67 regarding Art. 4 (similar to the exceptions found in Art. 4(1)(a)-(d) of the final Directive), the list of examples of possible exceptions was not considered to be exhaustive.[90] According to Art. 4(2) of the proposed directive, the Parent-Subsidiary Directive was to be applied instead. The proposed provision read:

> [...] Interest that has been re-characterized as a distribution of profits shall accordingly be subject instead to the provisions of Council Directive 90/435/EEC, where it is paid between companies to which the present Directive applies [...].

Moreover, in the Commission's explanatory memorandum, it was stated that Member States are permitted to exclude certain payments that may fall under the notion of interest but that *actually have the character* of distributed profits.[91] According to the Commission, this could arise, for example, under the provisions of a tax treaty or under the law of the Member State where the interest arises. Moreover, it was stated that interest that has been recharacterized as distributed profits ought to benefit from the provisions of the Parent-Subsidiary Directive in order to avoid double taxation of such profits.[92]

Recently, the Commission briefly dealt with the issue in a report to the Council, but no firm position was taken.[93] Based on a survey, the Commission found that there is a need for further reflection regarding the tax treatment of excess amounts of interest, whether or not reclassified as profit distributions. HFIs are, however, not specifically addressed in the Communication. Based on the above, there is, however, little doubt that the Commission intended the Parent-Subsidiary Directive to also apply to yield from HFIs, namely in situations where dividend classification follows from a tax treaty or from the

86. See Peeters and Van de Vijver, note 83, p. 150.
87. Para. 3 of the preamble reads: "whereas the existing tax provisions which govern the relations between parent companies and subsidiaries of different Member States vary appreciably from one Member State to another and are generally less advantageous than those applicable to parent companies and subsidiaries of the same Member State; whereas cooperation between companies in different Member States is thereby disadvantaged in comparison with cooperation between companies of the same Member State; whereas it is necessary to eliminate this disadvantage by the introduction of a common system in order to facilitate the grouping together of companies." See, for the interpretation suggested in the text, Brokelind, note 46, p. 327.
88. See, for example, F. Piltz, General Report, IFA *Cahiers de droit fiscal international*, "International aspects of thin capitalization", Vol. LXXXIb (Deventer: Kluwer, 1996), p. 136 et seq.; S. Næsborg Jensen, *EU-selskabsskatteret* (Copenhagen: DJØF Publishing, 1997), p. 226; Helminen, note 44, p. 331 et seq.; Maisto, note 58, p. 177 et seq.; K. Ståhl and R.P. Österman, *EG-skatteret* (Stockholm: Iustus, 2000), p. 214; J. Bundgaard, "Tynd kapitalisering – en skatteretlig fremstilling" (Copenhagen: Thomson, 2000), p. 296 et seq. Piltz presents three arguments that are against applying the Directive in cases of thin capitalization. First, the notion of dividends is not defined in the Parent-Subsidiary Directive, thus leaving the definition to the Member States. Second, the Directive does not contain rules on deductibility for expenses in the context of defining profits. Third, the Directive does not prevent the Member States from applying domestic legislation that prevents fraud and abuse; see Art. 1(2) of the Parent-Subsidiary Directive. On the other hand, it is argued that interest payments that have been reclassified as dividends should also enjoy the benefits of the Directive.
89. See Helminen, note 44, p. 268.
90. Id.
91. COM(1998) 67, regarding Art. 4, p. 8.
92. Id.
93. See note 36, p. 8.

domestic law of the source state.[94] This interpretation does not seem to embrace the autonomy theory, as presented in 3.1.1. regarding the notion of "distributions of profits".

Accordingly, if the proposal for the Interest and Royalties Directive does provide interpretative guidance with respect to the interpretation of the Parent-Subsidiary Directive, the question arises as to whether such guidance also applies to the state of residence of the recipient of the yield from an HFI. The Interest and Royalties Directive only applies to the source state in order to eliminate juridical double taxation on intra-group interest payments. However, as stated by Helminen, the explanatory memorandum only refers to double taxation in general and does not clarify whether this only covers juridical double taxation or also economic double taxation.[95]

The version of the Interest and Royalties Directive finally adopted contains different wording in Art. 4. This raises the question of which interpretative guidance (if any) should be accepted from the explanatory memorandum of the Commission. Helminen has stated that even though the reference to the Parent-Subsidiary Directive was ultimately not included in the final version of the Interest and Royalties Directive, the Commission's opinion promotes the interpretation that the benefits of the Parent-Subsidiary Directive should be available to interest on a hybrid debt that is treated as dividends under domestic law.[96]

Helminen states the following:

> [...] The P-S Directive should cover distributions from a subsidiary to a parent company on hybrid instruments classified as equity for domestic tax law purposes. If the source state taxes interest on hybrid debt as a dividend subject to withholding tax and denies an interest deduction, economic double taxation is the result. Because the purpose of the P-S Directive is to eliminate such double taxation in the relations between subsidiaries and parent companies, the P-S Directive should also be applied in these situations. If the source state treats an investment as equity and the interest on it as a dividend, it may not argue that the interest is not the kind of profit distribution covered by the P-S Directive [...].[97]

Eberhartinger and Six support the conclusion by stating the following:

> Since the purpose of the directive is precisely to eliminate such cases of double taxation, the directive has to be applied in these situations. This means, that payments on hybrid instruments, which are deemed returns on equity investment and, therefore, as dividends by the source state, would always have to be subject to the benefits of the Parent-Subsidiary Directive. Member States could, therefore, determine which hybrid instruments would benefit from the Parent-Subsidiary Directive via their treatment in national tax law [...][98] (footnotes omitted)

Brokelind, on the other hand, is sceptical whether the use of the legislator's opinion as expressed in the explanatory memorandum should justify the application of the Parent-Subsidiary Directive regarding reclassified interest.[99] The scepticism is based on: (1) the previous reluctance by the ECJ to rely on preparatory works with regard to the Parent-Subsidiary Directive in *Epson Europe BV*; and (2) the fact that it is doubtful that the ECJ would subject a directive to the application of a concept in a tax treaty, unless this was provided for in the directive itself.[100] Brokelind states that applying defined concepts arising from the Commentaries to the OECD Model in respect of the EU directives could have far-reaching and undesirable effects. For example, if the source state classification under Art. 10 of the OECD Model were accepted, domestic judges would be required to first verify the tax treaty that defined the income from HFIs before applying EU law. In conclusion, however, Brokelind states that the debate is still open and demonstrates the need for methodological guidance with regard to cross-border income classification problems.

The applicability of the Parent-Subsidiary Directive with regard to reclassified interest was, in fact, an issue in the *Lankhorst-Hohorst* case. However, the ECJ unfortunately did not decide on the matter. The issue was discussed in Paras. 100 et seq. of Advocate General Mischo's Opinion. The Danish government argued that Art. 5(1) of the Parent-Subsidiary Directive also applies to concealed dividends and, as such, such payments should also be exempt from withholding tax.[101]

In contrast, the German and UK governments argued that Art. 5(1) of the Parent-Subsidiary Directive did not apply in the situation in the case regarding the German thin capitalization provision in Sec. 8(a) of the Corporate Income Tax Act (*Körperschaftsteuergesetz*, KStG).[102] It was argued that the German taxation in the case should not be considered a withholding tax but instead an ordinary corporate tax. The Advocate General did not support this view. He stated that Art. 5 is not limited in its scope to specific taxes and that the classification of a tax is autonomous from domestic law (see *Athinaïki Zythopoïïa* in this regard).[103] The Commission, moreover, argued in the case that the German provision in Sec. 8(a) of the KStG fell under Art. 1(2) of the Parent-Subsidiary Directive (the anti-abuse provision). This argument was also rejected by the Advocate General,[104] who stated that

94. This is in line with the suggested interpretation of Helminen, note 44, pp. 267-268. See also Eberhartinger and Six, note 25, p. 226, stating (footnotes omitted): "[...] The logical consequence of this option is that payments on hybrid instruments between companies which fulfill the requirements of both directives are either subject to the Parent-Subsidiary Directive or to the Interest and Royalties Directive, depending on the treatment in the tax law of the source state or in the tax treaties between those countries [...]".
95. See Helminen, note 44, p. 268.
96. See M. Helminen, "The classification of cross-border payments on hybrid instruments", *Bulletin for International Fiscal Documentation* 1 (2004), pp. 60-61.
97. See Helminen, note 44, p. 267. The same conclusion is made at p. 282 regarding perpetual debt, at p. 291 regarding profit-participating debt instruments, at p. 301 regarding convertible bonds, at p. 309 regarding subordinated debt instruments and at p. 316 regarding preference shares.
98. See Eberhartinger and Six, note 25, pp. 225-227.
99. See Brokelind, note 46, p. 327.
100. Id.
101. See *Lankhorst-Hohorst*, Advocate General Mischo's Opinion, note 66, Para. 101. On this issue the view of the Danish government seems to be in accordance with Danish administrative practice on the subject, generally exempting disguised dividends from dividend withholding tax; see Circular 135 of 4 November 1988, Para. 102 and to this effect I.A. Strobel, "Maskeret udbytte", *SkatteOrientering* S.4. (1998), p. 29 et seq.
102. See *Lankhorst-Hohorst*, Advocate General Mischo's Opinion, note 66, Para. 102 et seq.
103. Id.
104. Id., Para. 116 et seq.

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once it is concluded that the legislation at issue cannot be justified on the basis of prevention of tax avoidance as an overriding reason in the public interest, this should also be the situation with regard to the anti-abuse provision of the Parent-Subsidiary Directive.[105] In conclusion, Advocate General Mischo supported the arguments presented by the Danish government, according to which Art. 5(1) should also apply to interest payments that are reclassified as dividends under the domestic thin capitalization provisions of Germany.[106]

The IBFD Survey interpreted the notion of distributions as follows:

> [...] a profit distribution linked to the status of shareholder of the recipient cannot be restricted to dividends proper, but must include all sums as distributions of income only because they are paid to a shareholder. In other words, the definition of "profit distributions" should comprise not only dividends proper but also constructive or hidden dividends. Therefore, excess interest treated as distributed income under the thin capitalization rules of certain Member States as well as advances to shareholders treated in the same way by the domestic legislation of the Member State from which the income is derived should qualify for tax relief under Art. 4 [...].[107]

The application of the Parent-Subsidiary Directive in cases where interest is reclassified as dividends in thin capitalization cases was also recognized by Avery Jones et al., who argued that "[...] the Parent-Subsidiary Directive would mean that there was no dividend withholding tax, which has resulted in EU states moving away from recharacterization as a dividend [...]."[108]

According to Thömmes, the objective of the directive can only be achieved if the Parent-Subsidiary Directive is applied to disguised profits as well.[109] The same can be said with regard to HFIs.

The points of view presented provide further arguments in favour of applying the Parent-Subsidiary Directive in cases of disguised dividend payments and reclassified interest payments. This should also affect the treatment of HFIs.

In summary, it can be concluded that there are solid arguments in favour of including the yield from HFIs within the scope of the Parent-Subsidiary Directive. This conclusion relies on a teleological interpretation of the Directive. Moreover, the analysis shows that a literal interpretation of the Parent-Subsidiary Directive does not exclude the yield from HFIs under the assumption that a shareholder relationship exists, which should then open up the possibility for a teleological interpretation. This follows from a literal interpretation of the term "income from shares" as applied by the ECJ, which cannot include yield on HFIs that are only in an economic sense considered equity. The use of the term "shares" seems to require that shares are, in fact, issued and that a shareholder position is, in fact, established. Such a position can hardly be created without complying with formal company law procedures. Accordingly, it is submitted that in order for the ECJ to potentially recognize yield on HFIs as dividends under the Parent-Subsidiary Directive, an existing shareholder relationship is required. If there is no shareholding, there would not appear to be a distribution either. Moreover, it is demonstrated in 5. that the holding requirement cannot be fulfilled by equity-like debt instruments.

3.2.4. Yield on instruments excluded from the scope of the Interest and Royalties Directive

The question needs to be addressed whether or not the excluded instruments mentioned in Art. 4 of the Interest and Royalties Directive, which are in fact HFIs, necessarily qualify as distributions of profits under the Parent-Subsidiary Directive.[110] If this is not the case, certain payments may fall outside the scope of both directives.[111] With regard to this question Eberhartinger and Six provide the following answer:

> From our point of view it seems reasonable to assume that the benefits of the Parent-Subsidiary Directive should always be applicable to payments on hybrid instruments in the national implementation of a Member State, if this Member State treats such payments as dividends under national tax law. In any case the Member State would be hard put to argue why these payments, representing dividends in national law, should be exempt from the benefits of the directive. Consequently profit distributions on hybrid instruments, which are qualified as interest in the Member State, should not benefit from the Parent-Subsidiary Directive [...].[112] (footnotes omitted)

The authors, however, conclude that the Interest and Royalties Directive leaves room for domestic tax policy measures in the Member State to exempt certain payments from the application of the Directive altogether, without having to include them within the scope of the Parent-Subsidiary Directive.[113] A similar result is proposed by Terra and Wattel: since the original proposal to refer to the Parent-Subsidiary Directive for income recharacterized as dividends was deleted in the final version of the Interest and Royalties Directive, this means that payments on hybrid loans may fall between the cracks.[114]

In the author's opinion the result of the analysis should be the same as the above analysis regarding interest reclassified from a thin capitalization/arm's length perspective and HFIs in general. The two situations overlap somewhat and may lead to the same unfavourable tax position. Therefore, if the conclusion is that Member States, by applying the exemption in Art. 4 of the Interest and Royalties Directive, can avoid granting the benefits under both directives, this should also apply to reclassified interest according to domestic thin capitalization

105. Id., Para. 117.
106. Id., Para. 109.
107. See Wijnen, note 80, p. 364.
108. See J.F. Avery Jones et al., "The Definitions of Dividends and Interest in the OECD Model: Something Lost in Translation?", *World Tax Journal* 1 (2009), p. 5 at p. 38 et seq. The article also appears in *British Tax Review* 4 (2009), p. 406. In footnote 214 it is stated that Germany applied the Parent-Subsidiary Directive under the previous thin capitalization legislation, which reclassified excess interest.
109. See note 70, regarding Sec. 6.1.
110. See Eberhartinger and Six, note 25, p. 227 et seq.
111. Id.
112. Id, p. 226.
113. Id., p. 229.
114. See Terra and Wattel, note 45, p. 621.

legislation. However, the intent of the Commission has been more clearly expressed with respect to yield on HFIs falling outside the scope of the Interest and Royalties Directive as a consequence of the application of Art. 4(1) of the Interest and Royalties Directive. One important difference should, however, be borne in mind – that Art. 4 of the Interest and Royalties Directive does not automatically apply to payments that are classified as dividends in the source state. The application of the Parent-Subsidiary Directive in such a situation could lead to a situation where yield not treated as dividends in the source state would be covered by the Parent-Subsidiary Directive. Such a result would go beyond the purpose of the directives.

3.3. Does the Parent-Subsidiary Directive permit classification inconsistencies?

An interesting general rule of interpretation is contained in Art. 7 of the previous proposal for the Parent-Subsidiary Directive. According to this provision, the Directive would have applied to any distribution that was considered a dividend distribution under the law of the source state. Such a rule of interpretation was not included in the version of the Parent-Subsidiary Directive finally adopted, and it is uncertain to what extent the definition contained in the previous draft version of the Directive will be accepted by the ECJ to provide guidance as regards the definition of the term "distributions of profits" in the version of the Directive adopted.[115]

The interpretations presented above concern the general scope of the Parent-Subsidiary Directive. Some of the statements in the tax literature primarily deal with the classification in the source state. Some authors are of the opinion that the source state must grant the benefits of the Directive in situations where the source state taxes debt as equity and interest as dividends. However, the answer is more problematic when it comes to determining whether or not the state of residence of the recipient of HFIs yield should respect the classification in the source state.[116] The reason for this is that such an interpretation would mean that the state of residence of the recipient could not tax certain interest payments, i.e. payments classified by the source state as dividends.[117]

Clearly, a fully autonomous EU notion of "distributions of profits" should be applied consistently and would not allow for an interpretation that depends on the source state classification. If, however, some room for domestic tax law classification remains (which seems to be generally accepted), this question is of great relevance. In practice, there will certainly be interpretations based on the domestic law of Member States. The question then is which classification should prevail, if any: the source state classification or the residence state classification?

Vanistendael has stated that the law of the source state should prevail and not the law of the country in which the dividend was received.[118] Vanistendael, seemingly, does not find that there is an obligation to apply a uniform interpretation *de lege lata*,[119] but strongly argues in favour of such a uniform interpretation *de sentenia ferenda*. He states that:

> [...] For the application of the directive it is essential that the concepts on both sides of the border are applied in the same way. This is particularly true for constructive dividends and financial instruments. At present Member States do have very divergent rules on the tax treatment of income from new financial instruments. A larger part of the remuneration of capital may escape the application of both the parent company directive and the interest royalty directive, when the concepts are not interpreted in the same way on both sides of the border.
>
> There are two ways of achieving this: (1) either the Member States agree on common definitions and treatment of dividends, interest and new financial instruments, which is highly unlikely, (2) or they agree on a common rule either the country of source or the country of residence as controlling in the interpretation of the qualification of the cross border payments [...].[120]

Helminen concludes that the limitations imposed on the Member States' taxation by the Parent-Subsidiary Directive should also apply to the state of the recipient of the payments, since the Parent-Subsidiary Directive requires that both economic and juridical double taxation be eliminated.[121] Thus, it is stated that in situations where the HFI is actually equity by nature, from an economic perspective, the state of residence of the interest recipient should also grant Parent-Subsidiary Directive benefits.[122] At the practical level Helminen recognizes that Member States may not agree with the method of interpretation presented above or may, with respect to the actual HFI in question, disagree on the proper classification thereof.[123] Thus, as a modification, the author states that it cannot be required that the recipient state, in any event, accept the classification, since this would give the source state too much power to collect tax revenues in comparison to the state of residence of an income recipient. [124] On this basis, Helminen suggests that the state of residence of the recipient of the payment should at least accept dividend classification under the Parent-Subsidiary Directive in situations where (1) the state must accept a dividend treatment for tax treaty purposes; and (2) where, in the reverse situation, the state itself would have reclassified the interest as a dividend. These two situations were also accepted by Eberhartinger and Six, even though the authors seem to take the opposite view

115. A similar issue does not arise under the Interest and Royalties Directive where the notion of interest is specifically defined in Art. 2(1)(a).
116. See Helminen, note 44, p. 267.
117. Id.
118. See F. Vanistendael, "Looking back: a decade of parent subsidiary directive – the case of Belgium", *EC Tax Review* 3 (2001), p. 162. This conclusion is also supported by C. Brokelind, *Une interpretation de la directive sociétés mères et filiales du 23 juillet 1990* (Brussels: Distribution Editions Bruylant, 2000), p. 319.
119. The same interpretation of the Parent-Subsidiary Directive is given by W. Kessler, *Der Betrieb* 2003/47, pp. 2512 and 2514; in support of this, see T. Kollruss, "Weisse und graue Einkünfte bei Outbound-Finanzierung einer auslandischen EU-Tochterkapitalgesellschaft nach Europarecht und dem JStG 2007", *Betriebs-Berater* 2007, p. 475, footnote 84.
120. See Vanistendael, note 118, p. 164.
121. See Helminen, note 96.
122. See Helminen, note 44, p. 267.
123. Id. See also Vanistendael, note 118, p. 161, stating that there may, in some cases, under Belgian law be double taxation if a reclassification of interest in the source state is not taken into account in the state of origin.
124. See Helminen, note 44.

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of Helminen at the level of principle; they state that, "[i]t clearly cannot be required of the parent state to accept the qualification of the source state in any case […]."[125]

Brokelind also supports the view that the concept of distributed profits is an autonomous EU law concept and that this concept covers interest treated as dividends in the source Member State.[126] Brokelind, however, states that there is no agreement in the doctrine on its extent or ECJ or national court cases regarding the applicability of the Parent-Subsidiary Directive with respect to HFIs.

In conclusion, there seems to be a certain degree of consensus in the tax commentary that the residence state should not per se respect the classification in the source state. However, to some extent the state of residence should respect the source state classification. This conclusion is primarily based on the relevance of the objective of the Parent-Subsidiary Directive to its interpretation. As demonstrated, a teleological interpretation is generally endorsed by the ECJ if this can be carried out within the framework of a literal interpretation. Accordingly, companies are left without any clear guidelines but an indication of the interpretive style of the ECJ regarding the influence of the source state classification with respect to HFIs.

3.4. Does the Parent-Subsidiary Directive permit reclassification of dividends (equity)?

In 3.3. an analysis was conducted of whether or not a Member State (i.e. the residence state of the recipient of the yield) should respect the reclassification of another Member State (i.e. the source state) of an HFI from debt to equity and thus should grant the benefits of the Parent-Subsidiary Directive with regard to such payments. However, a similar analysis has not been published regarding the question of whether or not a Member State is permitted under the Directive to reclassify a payment that would qualify for the benefits of the Directive had a reclassification not been made. Such a reclassification is often based on a substance-over-form approach under domestic tax law. This may, in principle, occur in situations where the benefit of the participation exemption or tax credit regime for inbound dividends under the Directive does not apply due to a domestic reclassification of the payment from dividends into interest payments or another category of taxable income. Moreover, this may, in principle, occur if a domestic reclassification allows for a withholding tax on interest payments due to a higher holding requirement under the Interest and Royalties Directive than under the Parent-Subsidiary Directive (25% compared to 10%). Basically, also in this area, the question is whether an autonomous interpretation is accepted or whether the Directive should be interpreted according to a domestic law classification.

On the basis of the ECJ's decision in *Traghetti del Mediterraneo SpA*,[127] it has been argued that the ECJ, in general, does not support a substance-over-form approach.[128] Based on conclusions regarding the ECJ decision, it has, moreover, been argued (by way of an example involving Danish law) that it is not possible for a Member State to separate the assessment of the facts from the provisions of the Parent-Subsidiary Directive. As such, a classification inconsistency between two states regarding the terms used in the Directive should not be allowed under EU law.[129]

Such a general principle of per se classification consistency based on an expansive and far-reaching interpretation of existing case law of a non-tax nature should, in the author's opinion, at the present stage of EU law, be rejected in the absence of any substantive support for such a result.[130]

As stated in 3.1.2.1., the concept of profit distributions should, in the view of several prominent authors, be interpreted not formally but substantively, covering any value shift to the parent company at the expense of the capital of the subsidiary in connection with the parent's provision of equity capital to the subsidiary, including constructive equity capital. If this analysis also applies in the opposite context, a reclassification of HFIs from equity to debt seems to be in accordance with the Parent-Subsidiary Directive. An important difference should, however, be observed regarding a narrow interpretation of the Parent-Subsidiary Directive (to exclude payments from the scope of the Directive) as compared to a broad interpretation (that includes payments within the scope of the Directive). Applying a broad interpretation that allows for HFIs to fall within the scope of the Parent-Subsidiary Directive does, in fact, ensure that the objective of the Directive is met, i.e. elimination of double taxation. If, however, a similar approach is adopted with respect to narrowing the scope of the Directive, this objective is not ensured. The leading ECJ case is *Kofoed*.[131] In this case the ECJ interpreted the Merger Directive (90/434/EEC) with regard to the notion of an

125. See Eberhartinger and Six, note 25, p. 227.
126. See Brokelind, note 46, p. 327 et seq.
127. ECJ, 13 June 2006, Case C-173/03, *Traghetti del Mediterraneo SpA, in liquidation v. Repubblica italiana*.
128. See S.F. Hansen, "Nekrolog over Realitetsgrundsætningen – En analyse af EF-domstolens dom af 5.7. 2007 i sag C-321/05, Kofoed mod Skatteministeriet", *Skattepolitisk Oversigt* 1 (2007), p. 1 et seq. Given the non-tax law context of the case, describing the nature of the case in this context would not be relevant.
129. Id., pp. 6-7.
130. The article does not analyse the very relevant subject of classification acceptance according to primary EU law in the context of HFIs. If such a principle of classification consistency exists, this should also influence the interpretation of the directives. See, in general, G. Fibbe, *EC Law Aspects of Hybrid Entities*, Doctoral Series Vol. 15 (Amsterdam: IBFD, 2009) on the relationship between the application of autonomous classification methods by Member States and EU law. Fibbe concludes that the disparity falls outside the scope of the Treaty on the Functioning of the European Union (TFEU, previously the EC Treaty) and can only be eliminated by policy at the EU level.
131. ECJ, 5 July 2007, Case C-321/05, *Hans Markus Kofoed v. Skatteministeriet*. See, for commentary, A. Zalasinski, "Case-Law-Based Anti-Avoidance Measures in Conflict with Proportionality Test – Comment on the ECJ Decision in *Kofoed*", *European Taxation* 12 (2007), p. 571 et seq.; M. Serup, *Fusionsskatteloven med kommentarer* (Copenhagen: Thomson Reuters, 2008), p. 65 et seq.; T. Rønfeldt and E. Werlauff, "Udbytte er udbytte og kan ikke vilkårligt omkvalificeres til at være f.eks. kontant udligningssum", TfS 2007.592; J.R. Stokholm, "Kommentar til EF-Domstolens dom af 5.7. 2007, Hans Markus Kofoed mod Skatteministeriet", Skat Udland 2007.342; T. Booker, "Skattemæssige omstruktureringer med særligt forkus på skattefri tilførsel af aktiver", TfS 2007.685; Hansen, note 128, p. 265 et seq.; S. Næsborg Jensen, "Kommentar til EF-domstolens afgørelse i Kofoed-sagen samt Skatteministeriets reaktion herop", SR-Skat (2008), p. 124 et seq.

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exchange of shares in Arts. 2(d) and 8(1). More specifically, the question was whether a dividend payment made immediately after the exchange of shares could be included in the calculation of the cash payment provided for in Art. 2(d). The Danish tax authorities had reclassified the dividend payments as cash payments in the transaction. The ECJ did not accept such a reclassification of dividends into cash payments. The relevant discussion is summarized in Paras. 28-29 and Paras. 31-33 of the decision.

> 28. The Court finds in this regard, as noted by the Advocate General in points 44 to 47 and points 52 and 53 of her Opinion, that the concept of "cash payment" within the meaning of Article 2(d) of Directive 90/434 covers monetary payments having the characteristics of genuine consideration for the acquisition, namely payments agreed upon in a binding manner in addition to the allotment of securities representing the share capital of the acquiring company, irrespective of any reasons underlying the acquisition.
>
> 29. Both the scheme and the logic of Directive 90/434 tend to support the position that the cash payment and the acquisition are part of the same transaction. The payment is part and parcel of the consideration paid by the acquiring company to the shareholders of the acquired company with a view to obtaining a majority holding in the latter.

See also Paras. 31-33 of the decision:

> 31. Consequently, a monetary payment made by an acquiring company to the shareholders of the acquired company cannot be classified as a "cash payment" for the purposes of Article 2(d) of Directive 90/434 merely because of a certain temporal or other type of link to the acquisition, or possible fraudulent intent. On the contrary, it is necessary to ascertain in each case, having regard to the circumstances as a whole, whether the payment in question has the characteristics of binding consideration for the acquisition.
>
> 32. That interpretation is supported by the purpose behind Directive 90/434, which is to eliminate fiscal barriers to cross-border restructuring of undertakings, by ensuring that any increases in the value of shares are not taxed before they are actually realised and by preventing operations involving high levels of capital gains realised on exchanges of shares from being exempt from income tax simply because they are part of a restructuring operation.
>
> 33. The Court finds that, in the main proceedings, there is nothing in the case-file demonstrating that the dividend in question formed an integral part of the necessary consideration to be paid by Dooralong for the acquisition of Cosmopolit, which is the necessary condition for it to qualify as a "cash payment" within the terms of Article 2(d) of Directive 90/434. On the contrary, according to the national court, it is common ground that at no time was there any agreement between Mr. Kofoed and Mr. Toft, on the one hand, and Dooralong, on the other, by which the latter was bound to distribute that dividend.

Thus, the ECJ rejects the possibility of reclassification of a payment under the Merger Directive if this is not in line with the objective of the Directive. A similar line of thinking could be followed with respect to the Parent-Subsidiary Directive and HFIs. The similarities include the absence of a precise definition of the notion at stake, as well as the importance of the objective of the Directive involved. Based on this, it may be argued that there is no support for interpreting the wording of the Parent-Subsidiary Directive in a narrow sense that deviates from a literal understanding of the Directive. This, however, would mostly be relevant when a domestic reclassification results in a disadvantage to the companies by way of double taxation. If no such double taxation occurs, it would be hard to follow a line of reasoning that relies on the objective of the Directive.

It, therefore, seems reasonable to conclude that Member States cannot narrow the scope of the Parent-Subsidiary Directive by way of reclassification of the yield from HFIs. This issue is analysed further in 4. in the specific context of cross-border tax arbitrage.

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