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Taxation of Cross border Hybrid Finance – A legal Analysis

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1. Introduction

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

Although hybrid instruments may be issued for a variety of non-tax reasons, taxation issues have a great impact on management’s finance decisions considering hybrid instruments. The reason for this is, that hybrid instruments from a fiscal point of view in the majority of countries can only be treated as either equity or debt. In other words the yield is either treated as profit distribution (or dividend, if one uses the term in a broad sense) or as interest, which again is crucial for two reasons: Firstly, this classification generally determines whether or not the issuer can treat the yield as tax-deductible, and secondly, in many cases it determines whether the payments received from the respective instrument are tax-exempt. Only in rare cases, the fiscal treatment of an instrument is split.

On part of the fiscal authorities, the wide variety and dynamic change of hybrid instruments in use, makes an unambiguous classification of each specific hybrid instrument all but impossible. The need to apply general criteria for the classification of hybrid instruments as equity or debt in turn constitutes important opportunities and risks for tax management.

This is even more important in international groups, where hybrid instruments can be used efficiently as flexible, tailor-made forms of finance, since in cross border situations both countries involved are faced with the problem of classification, which they will solve differently in certain cases. In some of these cases, when the payment is deductible as interest in the source state and exempt as a remuneration of equity (dividend) in the state of residence of the parent company, this will lead to double non-taxation of the yield. In the opposite case, where the hybrid instrument is treated as equity in the source state and as debt in the state of residence of the parent company, the differing classification might result in double taxation of the yield, if the payment is subject to withholding tax in the source state and to income tax in the state of residence of the parent company. This leads to the question, if and to what extent the national measures to avoid double taxation and the bilateral double taxation conventions are appropriate to avoid double taxation in these cases. Within the European Union additionally the applicability and efficiency of the EC Directives on the harmonisation of direct taxes in context with hybrid finance comes into question.

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1 Cf. the list of features of hybrid instruments that can blur the differentiation between equity and debt in Duncan (2000:24) and the various hybrid instruments analysed in the National Reports in the same Volume.
2 Note that the term Hybrid Finance as we use it, does not include derivatives (options, futures, swaps)
3 For examples for such reasons see Duncan (2000:24).
4 See e.g. Six (2007) with an analyses of the relevant provisions in the national tax law or eight central and eastern European countries and Wiedermann-Ondrej (2007) with an analysis of the relevant provisions in US tax law.
It is the aim of this paper to comprehensively demonstrate the possible fiscal consequences of intra group cross border hybrid finance on the basis of an abstract legal analysis of the relevant provisions in national, international and EC tax law.

As a result the paper (in particular in figures 2, 3 & 6) shows, that despite the different measures to avoid double taxation and to ensure single taxation of the remunerations on equity and debt within groups of companies, the use of hybrid instruments still can generate cases of double taxation as well as cases of double non taxation (white income). This is a major issue for taxmanagement because it implies that a group in a given set of countries can thus chose an appropriate instrument that allows for double non taxation in this setting. At the same time a group with given financial needs can chose appropriate countries for its subsidiaries in order to optimize or in certain cases eliminate the tax burden on the payments received. Furthermore, from the perspective of national and international legislators this result is important, because it shows that the existing system for the taxation of dividends and interest in the case of hybrid finance in many cases fails to ensure single taxation of the income received.

The focus of the paper rests on the theoretical case of an investor resident in country B, which finances an investee in country A using a hybrid instrument (figure 1). We assume that the yield of this hybrid instrument is defined as some share in profits, whereas no shareholder rights are connected to the instrument.

Figure 1: hybrid finance structure

to retain a feasible and concise level of complexity throughout the paper, the analysis is delimited to the effect of corporate income taxes (corporate taxes and withholding taxes) on hybrid finance. For the same reason we assume that both investor and investee are companies that are treated as intransparent for fiscal purposes by both countries and we do not consider the case of permanent establishments. Furthermore the effects of thin capitalization rules on the tax treatment of hybrid finance are not dealt with in this paper. In our analysis we assume that the transaction is at arm’s length and that no anti-avoidance rule is applicable.

The paper is organized in the following way. Section 2 focuses on a general discussion of the prevailing treatment of intra group cross border hybrid finance in the national tax laws. In section 3 the treatment of intra group cross border hybrid finance in the double tax treaties is discussed. Section 4 addresses the treatment of intra group cross border hybrid finance in the relevant EC Directives on direct taxation. Finally concluding remarks are provided in section 5 of the paper.

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6 For a detailed discussion on the treatment of hybrid finance in thin capitalization rules see Klostermann (2007).
2. Cross Border Hybrid Finance in the National Tax Laws

Each country in its (international) tax law generally has to deal with cross border hybrid finance in two basic situations: The first one of these is the case of inbound finance. In this case the investee is resident in said country (source state). Since we only look at intra group finance the investee in our case is a subsidiary in the legal form of a company resident in this country (subsidiary). The investor (parent) in this case is a company resident outside this country. The second situation is the exact opposite: a case of outbound finance. Here the parent is resident in said country (recipient state) and the subsidiary is resident outside this country. Again in our case both parent and subsidiary have the legal form of a company.

In this chapter we discuss each case in turn and give a survey of the typical fiscal consequences that may occur when using hybrid instruments in these cases. The effect of the relevant directives is not discussed in this chapter, since we will analyse the treatment of hybrid instruments in the EC Directives and their effect separately in chapter 4.

2.1. Inbound Finance

In the inbound case usually both subsidiary and parent are liable to corporate tax in the source state. Whereas the subsidiary, because of its residency in the source state, is liable to corporate tax on its total income, the parent (according to the territoriality principle) is normally only liable to some form of withholding tax on certain portions of its income originating from the source state.

As mentioned above in case of hybrid finance the relevant question in this context is, if the hybrid instrument used according to the national tax law of the source state is qualified as equity or debt.

At first glance this is of course very important for the subsidiary, because the yield of hybrid instruments qualified as equity is usually is treated as a profit distribution and therefore not tax deductible. The yield on hybrid instruments qualified as debt in contrast is usually tax deductible as interest.

In addition to that the result of the classification is also consequential for the parent, because the limited tax liability of the parent usually does not encompass any income originating from the source state, but only a limited list of forms of income, in which profit distributions (dividends) and interest may or may not be included. As a rule there is usually some form of withholding tax on dividends, whereas a withholding tax on interest is rather uncommon and restricted to certain forms of interest. There are however countries that do not levy a withholding tax at all. The bottom line is, that depending on the classification of the hybrid instrument, there may or may not be a withholding tax in the source state. Additionally on has to bear in mind that even if there is a withholding tax on both dividends and interest, the rate does not necessarily have to be the same but rather differs in many countries.

2.2. Outbound Finance

In the outbound case usually only the parent is liable to corporate tax, in this case on its worldwide income. In the case of hybrid finance again the relevant question is, if according to

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7 Austria (in simple terms) for example only levies a withholding tax (25%) on interest if the underlying debt is secured by mortgage in Austria. In Germany the withholding tax rate on dividends is 20%, the withholding tax rate on interest is 25% or in some cases even 33⅓% percent. In Hungary for example no withholding tax is levied on dividends and on interest. Cf e.g. Six (2007).
the national tax law of the recipient state the hybrid instrument used is qualified as equity or debt.

This classification is consequential for the parent insofar as income from debt claims (interest) is typically taxable, whereas profit distributions (dividends) in many cases, especially in the case of associated companies, are exempt or subject to reduced taxation. In this context it is important to note that the recipient state is by no means obliged to follow the classification as equity or debt by the source state, although some countries may link the fiscal treatment of the yield of hybrid instruments to the treatment in the source state.

Additionally some countries provide for unilateral measures to credit a foreign withholding tax (a withholding tax levied by the source state). In most of these cases the ordinary credit method is applied. This means that the recipient state credits foreign withholding only up to the amount of corporate tax levied on the same income. Often this credit method is combined with a per country limitation, which means that credit for withholding tax levied by a certain country is given only up to the amount of income received from said country.

2.3. Summary

The two key conclusions of this chapter in context with the taxation of cross border finance are (a) that the source state and the recipient state in some cases might not agree on the classification as equity or debt and (b) that in both countries dividends and interest might be taxed differently.

In certain cases therefore the source state will classify a specific hybrid instrument as debt, whereas the recipient state classifies the same instrument as equity. In some cases this will lead to total (triple) non-taxation of the profits (white income), if the payment is deductible as interest and not subject to withholding tax in the source state and at the same time exempt as a dividend in the state of residence of the parent company.

The opposite case, where the hybrid instrument is treated as equity in the source state and as debt in the state of residence of the parent company, might lead to economic and juridical double taxation (triple taxation), when the payment is not deductible and subject to withholding tax as dividend in the source state and subject to income tax (as dividend or interest) in the state of residence of the parent company.

Depending on the actual hybrid instrument a qualification conflict (a) in combination with a differential treatment of dividends and interest (b) diverging results in terms of the total tax burden on the hybrid finance, including cases of double taxation as well as cases of double non taxation, are therefore conceivable and have to be considered in tax planning.

Figure 2 gives an overview of these possible results. The classification as dividend by the source state in all cases but one leads to double or even triple taxation of the yield. Furthermore a qualification conflict in this case always leads to double taxation of the yield. Only if the source state and the recipient state unilaterally decide to exempt the yield from tax in the hands of the recipient (no withholding tax in the source state, no corporate tax in the recipient state) single taxation is ensured. The classification as interest by the source state as

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8 In Austria for example profit distributions between associated companies are exempt, if the parent holds at least 10% of the capital of the subsidiary for more than one year and if the subsidiary fulfils certain criteria concerning its legal form. Cf e.g. Six (2007).

9 In Italy the tax exemption regime for profit distributions only applies on hybrid finance if the income received, had not been deductible in the source state. Cf e.g. Six (2007).
expected leads to comparatively better results. In most cases the yield is only taxed once although in the recipient country, although even here double taxation is possible. Moreover in cases of a qualification conflict it is possible to generate cases where the tax burden is reduced to a withholding tax the source state or even cases of white income with a tax burden of zero.
Figure 2: Taxation of Cross Border Hybrid Finance without DTCs

Qualification in SS?

Corporate Tax in SS?¹

Withholding Tax in SS?²

Qualification in RS?

Corporate Tax in RS?³

Tax Credit in RS?⁴

TOTAL TAX BURDEN

SS  =  Source State
RS  =  Residence State
WI  =  White Income
cts = corporate tax in source state
ctr = corporate tax in recipient state
wts = withholding tax in source state
Notes on Figure 2:

1 Interest is generally fully tax deductible in the source state, dividends are generally fully taxable. We assume that no thin capitalization rule is applicable.

2 Note that in most cases there is some form of withholding tax on dividends. Nevertheless a withholding tax is not mandatory and there are countries that do not levy a withholding tax on dividends. Therefore both cases are depicted in figure 1.

3 Interest generally is always taxable in the hands of the recipient. For dividends unilateral tax relief in the form of a tax exemption is possible and indeed frequently used.

4 Unilateral relief in the form of a tax credit for withholding tax on dividends and interest is possible. Usually the ordinary credit method with a per-country limitation is applied and therefore depicted in figure 2. Note that no tax credit is given in cases where the income received is not subject to corporate tax in the recipient state, which implies that the recipient state does not provide for an unilateral relief at all or applies the ordinary credit method with a per country limitation.

3. Cross Border Hybrid Finance in Double Tax Conventions

As mentioned above in context with the taxation of cross border hybrid finance the treatment of hybrid instruments in the double taxation convention (DTC) between the source state and the recipient state is an important issue. Following the opinion of Lang\textsuperscript{10} that each DTC has to be interpreted autonomously, that is to say independent from the national tax law of the contracting states as long as no direct reference to the national law of one of the contracting states is made, the treatment of hybrid instruments as either dividend or interest in a DTC must primarily follow from the DTC itself.

In this chapter we discuss how and to what results for the total tax burden the yield on hybrid financial instruments can or must be qualified as either dividend or interest in the DTCs, irrespective of the treatment in contracting states. Following the general approach of the paper, instead of discussing any particular DTC, we chose to analyse the treatment of hybrid instruments in the relevant distributive rules of the OECD Model Tax Convention on Income and on Capital (OECD-MC), simply because the majority of the DTCs currently in force are based upon this Model Convention\textsuperscript{11} and most of them only marginally deviate from it in the articles relevant for this discussion.\textsuperscript{12} The analysis will show that the yield on hybrid instruments in the majority of cases either qualifies as dividend or interest in terms of the OECD-MC. The focus therefore rests on Art 10 (Dividends) and Art 11 (Interest) of the OECD-MC.\textsuperscript{13}

3.1. General remarks on the purpose and effect of Art 10 and 11 OECD-MC

Both Art 10 Dividends and Art 11 Interest in the OECD-MC grant the recipient state an unlimited right to tax the income received. They do not deny the source state its right to tax the income by levying withholding tax either. To avoid double taxation the OECD-MC obliges the state of residence to credit the withholding tax levied by the source state against the corporate tax levied. In Art 23 A and 23 B the OECD-MC in these cases stipulates the ordinary credit method with a per country limitation.

\textsuperscript{11} Cf. the Commentary on the OECD-MC [OECD-Com], Introduction, recital 13, and Vogel 2000:106.
\textsuperscript{12} See e.g. Six (2007) with a detailed analyses of the relevant provisions in the DTCs between Austria and Germany, Italy, Slovakia, Slovenia, Switzerland, Czech Republic and Hungary and Wiedermann-Ondrej (2007) on the mainly similar provisions in the US Treaties.
\textsuperscript{13} Art 7 (Business Profits) can be neglected in this context, since Art 7 (7) states that the provisions in Art 7 are not applicable on income which is dealt with separately in other Articles of the Convention.
Furthermore the OECD-MC curtails the right of the source state to levy withholding tax by limiting the amount of withholding tax the source state may levy: Art 10 limits the allowed withholding tax to 5% in case of associated companies and to 15% in all other cases, Art 11 limits the allowed withholding tax to 10%. Needless to say these limits are an important subject of the treaty negotiations and therefore single conventions may deviate considerably from the OECD-MC. For the same reason it is also possible that a specific DTCs denies the source state the right to levy withholding tax, which is more frequently the case for interest payments then for dividends.

The actual levels of withholding tax allowed for in the OECD-MC or in a specific DTC are not subject of this analysis. The relevant point here is, that the DTCs may grant the source state the right to levy withholding tax for both dividends and interest, for none of them and, most importantly, for only one of them.

Clearly this last case is important for of hybrid finance, because the classification of the yield as dividend or interest in this case is deciding in whether withholding tax can be levied or not. In the regular case where both countries apply the same classification criteria to decide whether the yield of a certain hybrid instrument must be subsumed under Art 10 or Art 11 it is merely a matter of taxmanagement to chose hybrid instruments whose yield would fall under the more favourable article of the DTC.

More difficult to solve is a situation where the DTC allows for a withholding tax in only one of the articles and the countries concerned do not subsume the yield of a certain hybrid instrument under the same article. Especially one problematic case may arise:

In this case the source state (country X) applies the article that allows for a withholding tax (say the dividend article) and therefore levies withholding tax in the stipulated amount. The state of residence of the recipient (country Y) on the other hand applies the article that does not allow for a withholding tax. Does Y have to credit the withholding tax levied in X, even if according to its interpretation of the treaty no such withholding tax is permitted?

Although parts of the German doctrine seem to hold the view that the state of residence is not obliged to apply the credit method in these cases, which would result in double taxation of the yield despite the DTC, this seems to be an unsolved problem. It seems feasible to assume that some countries may credit the withholding tax whereas other countries will deny a tax credit in these cases. In any case by this problem it becomes apparent, why the delimitation between the two relevant articles is a very important issue when using hybrid instruments, especially if one follows the opinion that each DTC has to be interpreted autonomously.

For this reason the subject of the following chapter is the analyses of the relevant provisions in Art 10 and 11 of the OECD-MC. The aim there is to show when exactly the yield on

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14 A minimum 25% holding in capital is required. On the question if hybrid instruments have to be included in the calculation of the minimum holding requirement see Six (2007).

15 In the case of interest payments some double taxation conventions even grants the source state no right to tax at all. See e.g. the double taxation convention between Austria and Switzerland (BGBl 64/1975, in force since 04.12.1974)

16 The same of course is true for cases where different levels of withholding tax are allowed for dividends and interest.

17 The same problem evidently also arises in cases where the relevant articles provide for differing maximum levels of withholding tax.

18 Cf. e.g. Wassermeyer 2004c:1701.

hybrid financial instruments can or must be qualified as either dividend or interest in terms of
the OECD-MC and if there is room for a divergent classification of the contracting countries.

3.2. Hybrid Finance in the OECD-MC

3.2.1. Hybrid Finance in Art 10: Dividends

Article 10 (3) OECD-MA defines the term dividends as follows:

“The term “dividends” as used in this Article means income from shares, “jouissance” shares
or “jouissance” rights, mining shares, founders’ shares or other rights not being debt-claims,
participating in profits, as well as income from other corporate rights,20 which is subjected to
the same taxation treatment as income from shares by the laws of the State of which the
company making the distribution is a resident.”

Art 10 (3) OECD-MC in the last sentence explicitly refers to the national law of the source
state and thereby makes this law part of the treaty between the two contracting states.21 On
principle it is debatable if this reference encompasses the whole definition of dividends or if it
only captures income from other corporate rights as in the second part of the definition. From
the wording of Art 10 (3) the reference clearly does not capture the income enumerated in the
first part of the definition. The terms income from shares, “jouissance” shares or
“jouissance” rights, mining shares, founders’ shares or other rights not being debt-claims,
participating in profits therefore have to be interpreted independent from the national law of
the source state.22 Consequently only income from other corporate rights is affected by the reference to the
national law of the source state, which according to the German doctrine23 only relates to the
taxation treatment as income from shares but not to the meaning of the term corporate rights
as used in the treaty. Accordingly this term has to be interpreted independent from the
national law of the source state as well. This means that the source state classification of a
certain hybrid instrument is relevant only if, from the perspective of an autonomous
interpretation, it is qualified as a corporate right.24 Additionally the use of the term other corporate rights instead of simply corporate rights
indicates that all the items of income enumerated in the Art 10 (3) OECD-MC have to be
corporate rights, in order for them to qualify under the definition in Art 10 (2) OECD-MC.25
Accordingly the yield of hybrid instrument, regardless if subsumed under the first or the
second part of the definition, will only qualify as dividend according to Art 10 (3) OECD-
MC, if the underlying hybrid instrument constitutes a corporate right in terms of the
convention.26

20 The OECD-Com explicitly states, that this enumeration may of course be adapted to the legal situation of the
states concerned and that this may be necessary in particular, as regards income from “jouissance” shares and
founders’ shares.
21 The German doctrine (e.g. Lang 1991:86) interprets this last sentence as a dynamic reference, which means
that the treaty does not refer to the law in force when the treaty was concluded, but to the applicable law
from time to time.
23 Cf. e.g. Lang 1991:90 and Vogel 1991:574.
Relevant criterion for the qualification as a corporate right in terms of the OECD-MC as well as for the delimitation from ‘debt-claims with a right to participate in the profits of the issuer’ is the right to benefit from a possible increment in the value of the company’s assets as remuneration for sharing the risk run by the enterprise. In other words an investment only qualifies as equity and therefore as dividend-generating, if the investor must accept the possible risk of the loss of the investment in a way comparable to the risk assumed by a shareholder.

A profit-participating right undisputedly is an essential characteristic for equity classification, but it alone clearly does not change the nature of debt to equity. According to the prevailing doctrine, the holder of a corporate right in addition to a profit-participating right must at least be entitled to participate in the liquidation proceeds of the company. This second criterion is fulfilled, if the holder participates in the hidden reserves of the issuing company, which means that the repayment has to be subordinated to the claims of other creditors.

The wording of Art 10 OECD-MC however does not explicitly list these criteria let alone go into detail on how these two criteria have to be formulated in order for a specific hybrid instrument to qualify as equity. The wide scope of possible characteristics of hybrid instruments (e.g. conversion rights, fixed repayment by a definite date, fixed minimum interest rates) consequently makes it difficult to decide, whether the two criteria mentioned above are fulfilled. Whether or not the extent of the profit participation and the extent of the participation in the liquidation proceeds combined impart enough participation in the entrepreneurial risk to allow for qualification of the financial instrument as a corporate right therefore must be evaluated in each individual case in light of all the characteristics of the financial instrument in question.

The extent of the control rights connected with a certain financial instrument however should have no influence on the character of equity or debt, because limitations in the control rights of a shareholder do not directly increase or decrease the risk component. As long as a the owner of a hybrid instrument participates in both the current profits and the liquidation proceeds, restrictions in the control right compared to those of a shareholder or the lack of such rights do not change the character of equity to debt.

### 3.2.2. Hybrid Finance in Art 11: Interest

Art 11 (3) of the OECD-MC provides the definition of the term interest. It reads as follows:

“The term "interest" as used in this Article 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 government 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 for the purpose of this Article.”

29 Helminen 1999:271; Lang 1991:124; Vogel 1991:573. The OECD-Com seems to share this view. Cf. para 25 of the commentary which among others lists the following examples for circumstances which indicate that a loan shares the risks run by a company: the level of payment of interest would depends on the profits of the company; the creditor will share in any profits of the company; repayment of the loan is subordinated to claims of other creditors or the payment of dividends.
Art 11 (3) OECD-MC contains no reference to the national law of one of the two contracting states and therefore has to be recognized as a final and all-embracing definition of the term interest as used in Art 11 OECD-MC, which has to be interpreted independent from the national law of either of the two contracting states.\(^{32}\)

According to Art 11, para 21 of the OECD Commentary to the OECD-MC (OECD-com) this is justified because

- “the definition covers practically all the kinds of income which are regarded as interest in the various domestic laws;
- the formula employed offers greater security from the legal point of view and ensures that conventions would be unaffected by future changes in any country’s domestic laws;
- in the Model Convention references to domestic laws should as far as possible be avoided.”

Central component of the definition is the term *income from debt-claims of every kind* which in itself is not defined in the OECD-MC or in the OECD-com, but merely complemented by an exemplary enumeration of certain kinds of debt claims (government securities and income from bonds or debentures), whereas this enumeration clearly does not influence the universal character of the term itself.

Even if Art 11 (3) OECD-MC contains no restrictions to the term, the leading doctrine correctly assumes that interest in this context generally encompasses remunerations for making capital available.\(^{33}\) In context with Hybrid Finance the problem is, that on one hand dividends in terms of Art 10 constitute remunerations for making capital available as well and on the other hand debt claims which carry a right to participate in the debtor’s profits are explicitly encompassed by the definition of interest in Art 11 (3). Therefore the question arises, how Art 10 (3) and Art 11 (3) OECD-MC are related.

In this context the OECD-com in Art 11 recital 19 implicitly acknowledges that any kind of income can only fall under one of the distributive rules in the OECD-MC\(^{34}\) by clarifying *that the term “interest” as used in Article 11 does not include items of income which are dealt with under Article 10*.

From the discussion of the scope of Article 10 follows, that the income from financial instruments which impart enough participation in the entrepreneurial risk to allow for a qualification as a corporate right, qualifies as dividend under Art 10 OECD-MC. Such yields *vice versa* cannot fall under Art 11 OECD-MC even if they would qualify as interest in terms of Art 11 (3) OECD-MC, because, according to the prevailing doctrine, the terms *income from corporate rights* and *income from debt claims* in context of the tax treaties are mutually exclusive.\(^{35}\)

Hybrid instruments with a profit-participating right as well as a right to participate in the liquidation proceeds of the issuing company from a DTC perspective therefore do not yield *income from debt claims* in terms of Art 11 (3) OECD-MC, but rather *income from corporate rights*.

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\(^{33}\) Cf e.g. Vogel 1991:655 et seq.

\(^{34}\) Cf. e.g. Lang 2002:202.

rights in terms of Art 10 (3) OECD-MC. The yield in these cases therefore qualifies as dividend in terms of Art 10 OECD-MC. On the other hand the yield of hybrid financial instruments which impart a participation in the entrepreneurial risk solely through a profit-participating right, e.g. if the payment of interest on a debt claim depends on profits being made, does not qualify as dividend but rather as interest in terms of Art 11 (3) OECD-MC.\textsuperscript{36}

3.3. Summary

The essential criterion for the delimitation between Art 10 and 11 OECD-MC is the existence of a corporate right. The yield of hybrid instruments which are qualified as corporate rights in terms of Art 10 OECD-MC is classified as dividend in terms of Art 10 whereas in all other cases the yield consequently classifies as Interest in terms of Art 11 OECD-MC. In order for an investment to qualify as a corporate right in terms of the OECD-MC, the investor must accept the possible risk of the loss of the investment in a way comparable to the risk assumed by a regular shareholder. According to the prevailing German doctrine this is the case, if the investment at least incorporates a participation in the profits as well as a participation in the liquidation proceeds of the issuing company. Only if these two criteria are fulfilled, the risk of the loss of the investment assumed by the investor is in a way comparable to the risk assumed by a regular shareholder.

The OECD-MC itself however does not explicitly list these criteria let alone go into detail on how these two criteria have to be formulated in order for a specific financial instrument to qualify as equity. In the case of hybrid instruments the wide scope of possible characteristics as regards the participation in the entrepreneurial risk makes for a difficult decision, whether the two criteria mentioned above are actually fulfilled in the individual case. This in turn will inevitably lead to situations, where the two contracting states do not agree on whether the characteristics for qualifying a specific hybrid instrument as a corporate right and thus as dividend-generating are present. Furthermore it seems reasonable to assume that countries in the application of their DTCs will primarily follow the classification of the yield in national tax law, which in some cases will not correspond.

In these cases it is possible that the tax payer will end up in a situation where one state applies Art 10 while the other applies Art 11, which depending on the provisions in the national tax laws and on the relevant DTC might result in double taxation or double non-taxation of the income received.\textsuperscript{37}

Figure 2 illustrates this result by extending figure 1 by the effect of the DTCs under the assumption, that each country applies Art 10 and 11 according to the classification of the yield as dividend or interest in its national tax law. It basically shows the same picture as figure 1 and thus demonstrates, that the DTCs in there current form are not an adequate tool to avoid double taxation or to ensure single taxation in case of hybrid finance.

In the case of a classification as dividend by the source state the DTC admittedly eliminates one case of triple taxation, but apart from that still all cases but one lead to double or even triple taxation of the yield. Here the one case with single taxation however may be caused partly by the DTC.\textsuperscript{38} This would be the case when the source state according to its national tax law would levy withholding tax but the dividend article in the DTC does not allow for a withholding tax. Nevertheless the single taxation in this case solely depends on the unilateral

\textsuperscript{36} Vogel 1991:657; Lang 1991:133.

\textsuperscript{37} In these cases the mutual agreement procedure remains as a last resort to solve the issue.

\textsuperscript{38}
decision of the recipient state to exempt the dividends from corporate tax, because according to the DTC it would be entitled to do so.

In the case of a classification as interest by the source state the effect of the DTC is remote as well. This is mainly because the yield would have been taxed once even without the DTC in most cases. Moreover the one case of double taxation resulting from a qualification conflict is still possible. On the other hand the DTC naturally does not influence the cases of white income. However, in the case where the only tax burden is a withholding tax in the source state the DTC might improve the situation further by reducing the amount of withholding tax the source state may levy.
Figure 3: Taxation of Cross Border Hybrid Finance under DTCs

SS = Source State  
RS = Residence State  
Wi = White Income  
ct = corporate tax in source state  
wts = withholding tax in source state
Notes on Figure 3:39

1 The DTC usually reduces the withholding tax in the source state or does not allow for the source state to levy withholding tax at all. If the source state according to its national tax law does not levy any withholding tax, the DTC has no effect.

2 The DTC usually does not change the right to tax dividend/interest income in the recipient state. The amount of corporate tax levied therefore would be the same as in figure 1.

3 Irrespective of the measures to avoid double taxation in the national tax law under a DTC the recipient state usually has to apply the credit method.

4 In cases where the source state applies a different article than the recipient state and according to this article levies withholding tax, it is not clear whether the recipient state has to apply the credit method, especially if according to its interpretation of the treaty an article applies, which does not allow for the source state to levy withholding tax. For this reason both alternatives are shown in figure 3.

4. Cross Border Hybrid Finance within the European Union

Within the EU, the right of legislation in the area of taxation is part of the sovereign right of each Member State, providing that State with autonomy of decision-making as regards its tax policy measures. In the area of direct taxation this autonomy, however, is considerably restricted by secondary EU law in the form of directives.40 Up to now, directives have been a major tool used by the Council in bringing the national law of the Member States into line with the requirements of a common domestic market within the European Community.41 Directives in the area of direct taxation, although few in number, are rather detailed and, thus, effectively constrain the Member States’ autonomy in implementing tax policy.

In context with the taxation of intra group cross border hybrid finance the PSD42 and the IRD43 are the most relevant of these directives, the first one dealing with dividend payments, the second one dealing with interest (and royalties) payments between associated companies. As explained above hybrid financial instruments combine elements of debt and equity, by definition.44 This means that the Member States’ classification of the relevant instrument as equity or as debt, respectively, for domestic tax purposes, defines the yield as a dividend or as an interest payment. This, in turn, may or may not fall within the scope of application of the PSD or of the IRD. Since these classification issues have immediate consequences for the total amount of income taxes levied by the Member States concerned, the following chapter deals with the effect of these two directives on the taxation of the yield of cross border hybrid finance.

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39 Also cf. the notes on figure 2.
40 Eberhartinger/Six 2007:213 with further references.
41 Art. 94 of the EC Treaty gives the Commission the right to propose to the Council directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market. Cf. Callies/Raffert 2007:1252 et seq.; Cf. Craig/De Búrca 2003:202, 1170, 1184; Bieber/Epiney/Haag 2005:193 & 305 et seq.
42 90/435/ECC
43 2003/49/EC

The Member States\textsuperscript{45} are obliged to implement EC directives into national law in compliance with the fundamental provisions of the EC treaty\textsuperscript{46}, but have freedom of choice as regards the form and the methods to be used in realising the aims of the directive.\textsuperscript{47} In this two-stage legislation process, the content of the final norm is defined by the institutions of the European Union, whereas the decision about the actual form lies in the competence of each Member State.\textsuperscript{48} The provisions of a directive therefore do not replace existing national law, but oblige the Member States to adapt their laws to the provisions of the directive. The measures to be taken are at the discretion of the Member State and depend on the national legal system.\textsuperscript{49} This leaves some leeway for the implementing authorities in respect of the form and the substance of the measure. Additionally there is some leeway for the member states concerning the interpretation of terms used in a directive that are not defined in the directive itself (or through ECJ Case Law concerning the directive).

All Member States are obliged to adapt their national law within the time limit in the directive.\textsuperscript{50} If a state failed to implement the directive in national law by the end of the period prescribed or failed to implement the directive correctly the provisions of the directive appear, as far as their subject is concerned, to be unconditional\textsuperscript{51} and sufficiently precise the ECJ in prevailing legal practise the European Court of Justice (ECJ) decided\textsuperscript{52} that the individual may rely on the provisions of the directive against the State (direct effect).

Up to date both the PSD (90/435/ECC) and the IRD (2003/49/EC) have been implemented by the majority of the member states.\textsuperscript{53}

\textsuperscript{45} Although directives, as opposed to regulations, do not have to be addressed to all Member States, most of them are addressed to all of them. Cf. Craig/De Búrca 2003:114; Prechal, 2005:55 with further evidence.
\textsuperscript{46} See e.g. ECJ, 24 September 2003, Case C-168/01, Bosal Holding BV v Staatssecretaris van Financiën, in connexion with the implementation of the PSD; Cf. with further references Zanotti 2004:502.
\textsuperscript{47} Art. 249, III ECT.
\textsuperscript{48} Cf. Haslach 2001:40, with further evidence.
\textsuperscript{49} According to Prechal 2005:76, the Member States have a choice between verbatim transposition on the one hand, and translation of the directive into legal concepts and terminology on the other (plus all possible combinations of the two).
\textsuperscript{50} This follows from Art. 10, I ECT. Before the time limit is reached, the directives already have legal effect insofar as the Member States “must refrain during that period from taking any measures liable seriously to compromise the result prescribed”, ECJ, 18 December 1997, Case C-129/96, Inter-Environnement Wallonie ASBL v Région wallonne; Cf. Prechal 2005:20; Bieber/Epiney/Haag 2005:194.
\textsuperscript{51} A provision is unconditional where it is not subject, in its implementation or effects, to the taking of any measure either by the institutions of the Community or by the Member State. See ECJ, 23 February 1994, Case C-236/92, Comitato di Coordinamento per la Difesa della Cava and others v. Regione Lombardia and others.
\textsuperscript{52} Cf. e.g. ECJ, 5 April 1979, Case C-148/78, Pubblico Ministero v Tullio Ratti; ECJ, 26 January 1984, Case C-301/82, SA Clin-Midy and others v Belgian State; ECJ, 26 February 1986, Case C-152/84, M. H. Marshall v Southampton and South-West Hampshire Area Health Authority (Teaching); ECJ, 23 February 1994, Case C-236/92, Comitato di Coordinamento per la Difesa della Cava and others v. Regione Lombardia and others; ECJ, 11 August 1995, Case C-431/92, Commission of the European Communities v Federal Republic of Germany (“Grollkrotzenburg”), Cf. also Craig/De Búrca 2003:202 et seq.; on the supremacy of EC law see e.g. ECJ, 15 July 1964, C-6/64, Flaminio Costa v E.N.E.L.; Craig/De Búrca 2003:186 et seq. & 275 et seq.
4.2. The Purpose and Effect of the Directives

The Parent-Subsidiary Directive was designed to eliminate tax obstacles in the process of the distribution of profits (dividends) from subsidiary to parent within the EU basically by

- abolishing withholding taxes on distributed profits between companies associated by a minimum holding in capital of at least 10% of different Member States in the source state, and

- preventing double taxation of parent companies on the profits of their subsidiaries in which they have a minimum holding in capital of at least 10%.\(^{54}\)

In implementing the PSD the Member States could choose between exempting from tax the profits received by the parent company, or giving credit for tax already paid.\(^{55}\) The majority of Member States opted for the exemption system for profits within the scope of the directive. For this reason the focus in this paper lies on the exemption method to show the tax effect of the PSD.

Figure 3 shows the effect of the PSD on the total tax burden borne by dividends received by the parent company, compared to the tax burden without the directive under the (imaginary worst case) assumption of no double-taxation treaty between the two States involved. It is also assumed that the State of the parent company does not provide any unilateral double-taxation relief measures. Corporation tax rates and withholding tax rates in both countries are assumed to be 25%.

Figure 4: Tax effect of the PSD

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SOURCE STATE:</strong></td>
<td></td>
</tr>
<tr>
<td>EBIT</td>
<td>100,000</td>
</tr>
<tr>
<td>Deductible Interest</td>
<td>0</td>
</tr>
<tr>
<td>EBT</td>
<td>100,000</td>
</tr>
<tr>
<td>Corporate Tax (25 %)</td>
<td>-25,000</td>
</tr>
<tr>
<td>Distributable Profit after Corporate Tax</td>
<td>75,000</td>
</tr>
<tr>
<td>Withholding Tax (25 %)</td>
<td>-18,750</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>56,250</td>
</tr>
<tr>
<td><strong>PARENT STATE:</strong></td>
<td></td>
</tr>
<tr>
<td>Dividends received</td>
<td>56,250</td>
</tr>
<tr>
<td>Tax Base for Corporate Tax</td>
<td>75,000</td>
</tr>
<tr>
<td>Corporate Tax (25 %)</td>
<td>-18,750</td>
</tr>
<tr>
<td>Income after Tax</td>
<td>37,500</td>
</tr>
<tr>
<td><strong>Total Tax Burden</strong></td>
<td>62,500</td>
</tr>
</tbody>
</table>

Source: Eberhartinger/Six (2007:219)

The primary aim of the Interest and Royalties Directive is to ensure that associated companies in different Member States are not discriminated against relative to associated companies in the same Member State through less favourable tax conditions than those

\(^{54}\) For a more detailed discussion of the provisions and terms of the directive that are relevant in context with cross border hybrid finance see e.g. Eberhartinger/Six, 2007:220. On the scope of application of the directive in general see e.g. Terra/Wattel 2005:491 et seq.

\(^{55}\) Cf. Art. 4 (1) of the Directive; Terra/Wattel 2005:504 et seq.
applicable to parent/subsidiary structures within a Member State. To achieve equal treatment of interest and royalty payments in the EU between companies associated by a minimum holding in capital of at least 10% the directive ensures that such payments are subject to tax only in the Member State of the beneficial owner. The source state has to exempt those payments from tax, including withholding tax.56

Figure 4 shows the effect of the IRD on interest received by the parent company, compared to the tax burden in the absence of the directive, on the (imaginary worst case) assumption that there was no double-taxation treaty between the two Member States involved, and that the Member State of the parent company did not provide any unilateral double-taxation relief measures. Corporation tax rates and withholding tax rates in both countries are assumed to be 25%.

### Figure 5: Tax effect of the IRD

<table>
<thead>
<tr>
<th>Source State:</th>
<th>before Interest and Royalties Directive</th>
<th>after Interest and Royalties Directive</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBIT</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Deductible Interest</td>
<td>-100,000</td>
<td>-100,000</td>
</tr>
<tr>
<td>EBT</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Corporate Tax (25 %)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Distributable Profit after Corporate Tax</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Withholding Tax (25 %)</td>
<td>-25,000</td>
<td>-25,000</td>
</tr>
<tr>
<td>Interest Paid</td>
<td>75,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Parent State:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Received</td>
<td>75,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Tax Base for Corporate Tax</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Corporate Tax (25 %)</td>
<td>-25,000</td>
<td>-25,000</td>
</tr>
<tr>
<td>Income after Tax</td>
<td>50,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Total Tax Burden</td>
<td>50,000</td>
<td>25,000</td>
</tr>
</tbody>
</table>

Source: Eberhartinger/Six (2007:223)

4.3. Hybrid Finance in the Directives

4.3.1. Hybrid Finance in the PSD

As explained above, the PSD applies to profit distributions to a parent company in one Member State by its (associated) subsidiary in another Member State. The directive explicitly states that Member States shall apply the PSD to distributions of profits (Art 1 (1), 90/435/ECC), that the state of residence of the parent company shall refrain from taxing such distributed profits (Art 4 (1), 90/435/ECC) and that profits, which a subsidiary distributes to its parent company, shall be exempt from withholding tax (Art 5 (1), 90/435/ECC). Interestingly though, the PSD itself contains no definition of the term profits.

Although the terms ‘dividends’ and ‘distributed profits’ or ‘profit distributions’ are often used synonymously, the latter has a broader scope including other profit distributions as well, but

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56 For a more detailed discussion of the provisions and terms of the directive that are relevant in context with cross border hybrid finance see e.g. Eberhartinger/Six, 2007:222. On the scope of application of the directive in general see e.g. Terra/Wattel 2005:625 et seq.
unquestionably includes dividends. In the introduction to directive 2003/123/EC the Council of the European Communities itself states that the objective of the PSD is to exempt “dividends and other profit distributions”. The term profit distributions in this context could be interpreted to cover any payment based on the shareholder-company relationship or the association between companies. Therefore it seems that the directive leaves it to the Member states and their national definitions to decide which profits to include within the scope of the national application of the directive.

In the context of hybrid finance the questions arises:

Do payments on hybrid instruments qualify as distributed profits in terms of Art 1 of the PSD at all, and if so, which instruments would have to be included?

To answer this question, it is necessary to have a look at the aim of the PSD, which is essentially the elimination of double taxation in the relations between parent companies and subsidiaries, in context with hybrid finance.

As shown above, should the source state classify a hybrid instrument as equity and, thus, deny a tax deduction on the payments on the instrument, multiple taxation is possible. It seems reasonable to assume that the PSD has to be applied in these situations, since the purpose of the directive is precisely to eliminate such cases of double taxation. Payments on hybrid instruments, which are deemed returns on equity investment, therefore, would always have to be subject to the benefits of the PSD.

Some evidence that this is indeed what the legislator intended can be found in the materials to the IRD:

In the Proposal for the IRD the last section of Art 4, which amongst others contains an option for Member States to exempt payments from the benefits of the directive which are treated as a distribution of profits or as a repayment of capital under the law of the source state, contains:

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

Note that since the PSD does not employ the term dividend as in Art. 10, Section 3 of the OECD Model Convention, the definition of the term dividend in the OECD Commentary on Article 10 can only be applied conditionally to the term profit distributions in the PSD.

Subsequently the question arises, if participation via hybrid instruments attributes to the 10% holding level required by the PSD in Art 3 at all and if so, which instruments would have to be included. For a discussion of this issue cf Eberhartinger/Six, 2007:226.

See Terra/Wattel 2005:514 et seq.; Helminen 2004:60; Helminen 1999:266. Also see chapter B on the Member States obligation to implement the directive according to the objectives specified by the Council.

Cf. the preamble to 2003/123/EC and the preamble to 90/435/EEC; Helminen 1999:266.


State,\textsuperscript{66} indicates that this interpretation of the term profit distribution corresponds to an (at least originally) intended interrelation between the two directives. It reads as follows:

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

The proposed text seems to refer primarily to thin capitalisation and disguised dividends. The commentary on the Proposal for the IRD stated that such a switch in the applicable directive could arise, if for example the re-characterisation as a distribution of profits follows from a DTC between two Member States or is based on the domestic tax law of the source state.\textsuperscript{67}

Nevertheless Helminen\textsuperscript{68} correctly states, that one could deduce from these text passages that the Commission was of the opinion that income from hybrid instruments should usually qualify as a profit distribution under the PSD, if treated as a dividend in the source state or if treated as a dividend for DTC purposes. The logical consequence of this opinion is that payments on hybrid instruments which generally fulfil the requirements of both directives\textsuperscript{69} are either subject to the PSD or to the IRD, depending on the treatment in the tax law of the source state or in the tax treaties between those countries.\textsuperscript{70}

Interestingly though, the reference to the PSD is not included in the final legal version of the IRD. One could argue that this simply shows that, in the opinion of the Commission, payments on hybrid instruments that have been excluded from the benefits of the IRD on the basis of Art 4(a), necessarily qualify as profit distributions in the terms of the PSD. Otherwise, it would be possible that such payments do not fall within the scope of either of these directives.

From our point of view it seems reasonable to assume that the benefits of the PSD 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.\textsuperscript{71} Nevertheless it is possible to interpret the term profit distribution as to cover only income from classic shares, and as long as no definition of the term profit distribution is provided, some Member States may do so.\textsuperscript{72}

Assuming that the source state must grant the benefits of the Parent-Subsidiary in cases where hybrid instruments qualify as equity in national tax law, the question arises whether the state of residence of the parent company has to grant these benefits symmetrically, thereby accepting the classification of the source state. If it does not, either because of a different

\textsuperscript{66} On the other options in Art 4 IRD see section 4.3.2. and Eberhartinger/Six 2007:227.


\textsuperscript{68} Helminen 2004:60.

\textsuperscript{69} For example the minimum requirements for the holding in capital under both directives would have to be fulfilled, which would be the case anyway, if the parent company held more than 25% in the capital of the subsidiary. Cf. Chapters C and D for the scope of the directives.

\textsuperscript{70} This opinion seems to be confirmed by Para. 19 of the Commentary on Art. 11 of the OECD Model Tax Convention 2005 which in the context of thin capitalization cases states that, “it should be noted that the term “interest” as used in Art. 11 does not include items of income which are dealt with under Art. 10”.

\textsuperscript{71} Consequently profit distributions on hybrid instruments, which are qualified as interest in that Member State, should not benefit form the Parents-Subsidiary Directive.

\textsuperscript{72} Cf. Tumpel 1998:261.
interpretation of the term profit distribution or because of a classification of the yield as interest (classification conflict), it would be possible for the recipient state to levy income tax on the profits distributed by the subsidiary, even though the source state applies the PSD. Such an asymmetrical treatment would result in (economic) double taxation of the yield.

In our opinion it clearly cannot be required of the recipient state to accept the classification of the source state in any case, so these cases of double taxation are still possible despite the directive. In respect of the fundamental aims of the PSD Helminen

nevertheless is right when arguing that the recipient state should follow the treatment in the source state at least in the following two cases:

- If, in the opposite situation, the recipient state itself would have qualified the hybrid instrument as equity.
- If the recipient state has to accept a treatment as equity for DTC purposes.

4.3.2. Hybrid Finance in the IRD

The term interest in the IRD is defined as follows:

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

The IRD thus contains a very wide definition of the term interest (“Income from debt claims of any kind”) that encompasses almost any kind of hybrid instrument. At the same time though the IRD allows Member States to deny the benefits of the directive in four cases listed in Art 4, thus enabling them to narrow the scope of application of the directive considerably. Of these four the options in Art 4(a) and Art 4(b) are of special relevance for this analysis.

Art 4(a) IRD allows the source state to exempt payments which are treated as a distribution of profits or as a repayment of capital under its domestic law from the benefits of the directive. As explained above from the perspective of hybrid finance this is a most interesting provision, since it is not clear whether these payments, if the option is executed and provided the other requirements are met, necessarily fall under the scope of application of the PSD. As mentioned above, this connection was explicitly stated in the Proposal for the IRD in 1998 and it is not apparent why this statement was not included in the final version of the directive.

In our opinion it can be assumed that it was indeed the intention of the Commission, that such payments fall under the scope of the PSD. In this case, independent of how the source state executes the option in Art 4(a), no withholding tax would be levied. Thus the requirements of a common single market as defined in the preambles to the two directives would be

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73 Helminen 1999:269.
74 Art 2, 2003/49/EC.
75 For an analysis of all for options in Art 4 in context with hybrid finance see Eberhartinger/Six, 2007:227.
fulfilled.\textsuperscript{78} This of course raises the question, why Art 4(a) of the directive gives the Member States an option instead of generally exempting such payments from the scope of the directive. What if the source state does not execute the option in Art 4(a) of the IRD? It seems that these payments would then fall under the scope of both directives. Since both directives prescribe an exemption from any withholding tax on the payments, the effect on the tax burden would be the same, but it nevertheless seems interesting that under these circumstances the same payment might qualify as interest and as profit distribution.

In addition to Art 4(a) Art 4(b) allows the exemption of debt-claims which carry a right to participate in the debtor’s profits.\textsuperscript{79} The source state, therefore, has the option to exclude most hybrid instruments from the scope of application of the IRD. Additionally, by qualifying certain hybrid instruments as debt on a national level, the source state could exempt them from the benefits of the PSD. In context with the option in Art 4(b) it is therefore possible for the source state to exempt certain hybrid instruments from the benefits of both directives.

In our opinion Art 4(b) (as well as Art 4(c) and (d)) only applies to cases where the treatment under the domestic tax law of the source state corresponds to the general definition of interest in Art 2(1) of the directive. This means that Member States can decide to exempt payments on certain (hybrid) financial instruments from the benefits of the directive, while still qualifying the same payments as interest in domestic tax law. Thus Art 4 seems to foil the general aim of the IRD, which is to eliminate double taxation on interest payments.

\textit{Distaso/Russo}\textsuperscript{80} argue that the intention behind these provisions might be to give Member States a tool to eliminate cases of double non-taxation, by excluding instruments that create a tax deduction in the source state, while giving rise to an exemption from taxation of the corresponding income received (e.g. because the recipient state treats the income as profit distributions and applies the PSD). Assuming that this was indeed the ratio behind Art 4, the provision seems to be a rather inadequate instrument. Firstly the directive affects not only payments between one pair of Member States, but all payments within its scope. Secondly Art 4 includes no reference to the treatment of the payments in the recipient. It is therefore possible for the source state to exempt payments from the scope of the directive which are treated symmetrically as interest in both states, thereby creating double taxation instead of avoiding double non-taxation, specifically.

4.4. \textbf{Summary}

The bottom line of the analysis in this chapter is that both directives leave room for the Member States to exclude certain hybrid instruments from the benefits of both directives. Some countries therefore may levy withholding tax in the inbound cases and/or levy corporate tax on the yield in outbound cases.

This situation is illustrated in figure 6, which extends figure 3 by the effect of the directives. Both figures show a very similar picture, which implies that the directives in their current form fail to ensure single taxation in case of hybrid finance. Depending on the pair of

\textsuperscript{78} Cf. Para. (1) of the Preamble to the Interest and Royalties Directive and Para. (1) of the Preamble to the Parent-Subsidiary Directive.

\textsuperscript{79} Since Art. 4 (b) refers only to participation in the debtor’s profits a literal interpretation would mean that interest payments connected to another entity, e.g. a subsidiary of the debtor, would not be included in the option. Cf. \textit{Distaso/Russo} 2004:150.

\textsuperscript{80} \textit{Distaso/Russo} 2004:150.
countries and the hybrid instrument used, more or less the same cases of double taxation and
double non taxation are possible as in the non EU case. In connection with a qualification
conflict even triple taxation is still possible, if the source state treats the yield as non tax
deductible but does not apply the PSD, while the recipient state treats the yield as interest, but
despite the DTC does not credit the withholding tax levied by the source state.
Figure 6: Taxation of Cross Border Hybrid Finance under DTCs within the EU

Qualification in SS?

Corporate Tax in SS?

Covered by PSD?\(^1\)

Covered by IRD?\(^2\)

Withholding Tax in SS?

Qualification in RS?

Corporate Tax in RS?

Covered by PSD?\(^3\)

Tax Credit in RS?

TOTAL TAX BURDEN

SS = Source State
RS = Residence State
PSD = Parent Subsidiary Directive
IRD = Interest and Royalties Directive
WI = White Income

c_{ts} = corporate tax in source state
c_{tr} = corporate tax in residence state
w_{ts} = withholding tax in source state
Notes on Figure 6: 

1. Whether the yield of a hybrid instrument that is classified as dividend in the source state is covered by the PSD depends on the interpretation of the term profit distribution in the directive. In our opinion the directive covers these cases as well, but it is possible that some countries interpret the term profit distribution as to cover only income from classic shares. Therefore both cases are depicted.

2. If none of the options in Art 4 of the IRD is executed, the yield of almost any hybrid instrument is covered by the IRD. It is therefore possible that a certain hybrid instrument falls within the scope of both directives. If the option in Art 4a of the IRD is executed, the hybrid instrument may be covered by the PSD, but from the wording of the directives this is not mandatory. It is therefore possible, that the yield of hybrid instrument that is qualified as dividend by the source state is not covered by either of the directives, which means that despite the directives withholding tax can be levied. If the option in Art 4b is executed the yield of a hybrid instrument qualified as interest by the source state is not covered by the IRD, which means that withholding tax can be levied.

3. Even if none of the directives is applicable, it is possible that the source state (either according to national tax law or because of the DTC) levies no withholding tax (cf. figure 2 and 3).

4. Whether the yield of a hybrid instrument that is classified as dividend by the recipient state is covered by the PSD depends on the interpretation of the term profit distribution in the directive. In our opinion the directive covers these cases as well, but it is possible that some countries interpret the term profit distribution as to cover only income from classic shares. Therefore both cases are depicted.

5. The recipient state for the application of the PSD from the wording of the directive clearly does not have to follow the treatment in the source state. Nevertheless some countries, in order to avoid economic double taxation, reasonably may choose to apply the PSD on the yield of hybrid instruments in cases where the source state qualified the hybrid instrument as equity and applied the PSD.

6. Even if the PSD is not applicable (see note 4), some hybrid instruments may fall within the scope of application of some form of national exemption provision and thus implicitly implement the directive.

7. In cases where the source state applies a different article than the recipient state and according to this article levies withholding tax, it is not clear whether the recipient state has to apply the credit method, especially if according to its interpretation of the treaty an article applies, which does not allow for the source state to levy withholding tax. For this reason both alternatives are shown in figure 6.

5. Conclusion

Figures 2, 3 and 6 reflect the high complexity of the taxation of intra group cross border hybrid finance. Obviously this complexity increases the more jurisdictions and legal levels are concerned.

On the level of national tax law the problem of the classification of hybrid instruments as either equity or debt creates legal uncertainty. Depending on how the countries involved solve this problem, cases of double and triple taxation as well as cases of double non taxation (white income) are possible. In a given set of countries the tax burden may therefore vary considerably depending on the specific hybrid instrument used.

The inclusion of DTCs in the analysis increases the legal uncertainty, while not necessarily reducing double taxation. The reason for this is the additional uncertainty in context with the interpretation of the DTC by the countries involved, which is mainly caused by the lack of a clear-cut delimitation between dividends and interest in most DTCs.

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81 Also cf. the notes on figure 2 and 3.
EU tax law, despite two directives focusing on cross border intra group finance, as well is not fit to cover hybrid finance in a way to ensure single taxation. The reason here is primarily the indistinct interdependence between the two directives. Moreover the effect of the IRD in cases of hybrid finance is foiled by extensive exclusion options. As a result, the tax treatment of intra group cross border hybrid finance in the EU is by no means straightforward. On the contrary it seems that the situation becomes rather more complicated, due to the increased legal uncertainty caused by the potentially differing implementation of the directives in the countries involved.

As a result, despite the different measures to avoid double taxation and to ensure single taxation of the remunerations on equity and debt within groups of companies, in cases of hybrid finance double taxation as well as cases of double non taxation (white income) are still possible. The actual tax treatment of a given hybrid instrument thereby largely depends on the solution of a variety of classification and interpretation issues by the two countries concerned. As a result taxpayers are faced with considerable legal uncertainty as to the fiscal consequences of the use of hybrid instruments in cross border intra group finance.

From the perspective of national and international legislators this seems to be a rather dissatisfactory result, because it shows that the existing system for the taxation of dividends and interest in the case of hybrid finance in many cases fails to ensure single taxation of the income received.

From the perspective of taxmanagement this situation on the other hand holds considerable potential, because it implies that a group in a given set of countries may be able to choose an appropriate hybrid instrument that allows for double non taxation in this setting, thus creating white income. At the same time a group with given financial needs may be able to chose appropriate countries for its subsidiaries in order to optimize or in certain cases eliminate the tax burden on the payments received.
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