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Article

The Proposal for an EU Anti-avoidance Directive: Some Preliminary Thoughts

Aitor Navarro, Leopoldo Parada & Paloma Schwarz*

On 28 January 2016, the European Commission made public a package of measures aimed to tackle tax avoidance and abusive practices in the European internal market. The package includes a detailed proposal for a new European Union (EU) Anti-avoidance Directive addressing six main issues: deductibility of interest; exit taxation; switch-over clause; General Anti-avoidance Rule (GAAR); Controlled Foreign Corporation (CFC) rules; and hybrid mismatches. This article provides a critical analysis of the Proposal for a Directive taking into consideration some of the implications of its implementation at stake. The final aim of this work is to contribute some elements that can improve the future debate on these matters.

1 Introduction

The European Commission has recently issued a proposal for a Council Directive that lays down legally binding rules against tax avoidance practices that affect the functioning of the internal market.[1] The proposed Directive is part of a full Commission's Anti-Tax Avoidance Package[2] that intends to address a number of issues connected to the 2013 OECD/G-20 Base Erosion and Profit Shifting (BEPS) project,[3] and which is also in line with the Action Plan for Fair and Efficient Corporate Taxation presented by the Commission on 17 June 2015[4] that intends to re-launch a proposal for a Common Consolidated Corporate Tax Base (CCCTB) in the European Union.[5]

The main purpose of the Proposal for a Directive is to provide a coherent and coordinated transposition of the OECD BEPS measures within the European Union (EU) by creating minimum anti-abuse standards that permit to tackle situations in which corporate taxpayers make use of the disparities between the different domestic tax systems in the Member States.[6] The EU Anti-avoidance Directive contains specific measures in different fields including: deductibility of interest; exit taxation; switch-over clause; the inclusion of a General Anti-avoidance Rule (GAAR); Controlled Foreign Corporation (CFC) rules; and hybrid mismatches.

This article has the purpose of providing a critical analysis of the Proposal for a Directive considering some of the implications of its implementation at stake. Therefore, this work does not pretend to deal in detail with each one of the implications that could arise from the implementation of the Proposal, but to focus on

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1 The details of the implementation are left to the Member States. See Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market, COM (2016) 26 final (hereinafter, 'Proposal for an EU Anti-Avoidance Directive', 'Proposal for a Directive' or 'Proposal').

2 Other initiatives include: a recommendation on tax treaties; a revision of the Administrative Cooperation Directive; a Communication on an external Strategy for Effective Taxation and a Chapeau Communication and Staff Working Document, which explain the political and economic rationale behind the individual measures.

3 OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing, Paris. See also OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Paris. Both will be further referred as the 'BEPS Project'.

4 Commission Communication, *A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action*, COM (2015) 302 final, 17/6/2015. See also, e.g., Sebastian Krauß, *EU-BEPS? Aktionsplan für eine faire und effiziente Unternehmensbesteuerung in der EU,* Internationales Steuerrecht 2, 45 et seq. (2016).

5 For an analysis on the CCTB proposal see, e.g., Luca Cerioni, *The Commission's Proposal for a CCCTB Directive: Analysis and Comment*, 65 Bull. Intl. Taxn. 9 (2011). See also, Jesper Barenfeld, *A Common Consolidated Corporate Tax Base in the European Union–A beauty or a beast in the quest for tax simplicity*, 61 Bull. Intl. Taxn. 7 (2007).

6 Supra n. 1, at 4.

specific matters that, under the authors' view, are considered to be more controversial. The final aim of this work is to contribute some elements that can improve the future debate on these matters. Additionally, this article will not deal with the lack of competence or treaty override issues in a detailed manner, although these issues might be lightly mentioned in the analysis of some specific measures during this work.

Section II briefly describes the six measures contained in the Proposal for a Directive, providing a critical analysis of some immediate consequences derived from its implementation at stake. Section 3 provides the conclusions.

2 Analysis of the Proposal for a Directive

2.1 Interest Limitation Rule

The Proposal contains a so-called interest limitation rule, which establishes a threshold for the deductibility of borrowing costs that exceed 30% of the taxpayer EBITDA or up to EUR 1,000,000 – whichever is higher – and a carry forward for this amount to be deducted in future tax years.[7] Likewise, the EBITDA of a tax year that it is not fully absorbed by the borrowing costs incurred by the taxpayer in that tax year or previous ones may be carried forward.[8] This rule seems to be influenced by Article 4h of the German Income Tax Code (*Einkommensteuergesetz*),[9] and it is also in line with one of the 'key pressure areas' addressed by the BEPS initiative Action 4.[10]

The interest limitation rule serves the purpose of mitigating the difference on the tax treatment of debt as an instrument that generates deductible payments, and equity, the payments of which are generally non-deductible.[11]

2.1.1. *Non-compatibility with Fiscal Unity Regimes*

A first relevant issue that must be addressed regards whether domestic fiscal unity regimes entail the application of the interest limitation rule to a whole group or whether they have to be applied on an entity-by-entity basis. The Proposal determines a minimum standard of anti-avoidance measures that may be strengthened by the Member States if they consider it necessary in order to establish a higher level of protection for their corporate tax bases.[12] Notwithstanding the above, the effect of the combination of a fiscal unity regime and the interest limitation rule could lead to a more beneficial result to the taxpayer. This is because such an aggregation would improve the relation of net interest expenses and EBITDA compared to non-fiscal unity.[13]

Considering the Proposal for a Directive does not provide any guidance upon this issue, the only conclusion for these authors is that the interest limitation rule should be applied on an entity-by-entity level. This is to say, countries, which permit the combination of both regimes, e.g., Germany[14] and Spain,[15] will have to modify their domestic rules on that regard if the Proposal for a Directive is enacted.

2.1.2. *Interest Limitation Rule as an Anti-avoidance Measure*

An anti-avoidance measure should tackle only abusive situations and leave unaltered those other situations not considered as abusive. From this point of view, the authors have serious doubts whether the interest limitation rule qualifies as an anti-avoidance measure, considering it does not make a distinction over the real finance structure needs of the taxpayer, namely, it does not distinguish between industries, market sectors, and the specific circumstances of each firm.[16] It is unquestionable that a firm in the technological sector should not, from a financial point of view, hold the same leverage ratio as a firm in the car industry or in the web-based services sector. Thus, an interest limitation based on fixed parameters – 30% EBITDA or EUR 1,000,000 – should be regarded as suitable to combat base erosion and thus contribute to raise revenue, but not to be

7 Article 4 of the Proposal for a Directive, supra n. 1.

8 *Ibid.* There are also two exceptions to this rule which have been introduced: One says the taxpayer may be given the right to fully deduct excess borrowing costs if the taxpayer can demonstrate the ratio of equity over total assets is equal to or higher than the equivalent ratio of the group; The other states that financial undertakings may deduct financial payments without the limits posed above. Accordingly, Art. 2(4) determines which entities must be considered as financial undertakings for purposes of the proposal. See Art. 2(4) of the Proposal for a Directive, supra n. 1.

9 On the German interest limitation provision (*Zinsschranke*) see, e.g., Klaus von Brocke & Eugenio García Pérez, *Group Financing: From Thin Capitalization to Interest Deduction Limitation Rules*, 16 Intl. Transfer Pricing J. 1 (2009).

10 See OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments. Action 4: 2015 Final Report* (2015). Nevertheless, the decision of whether a company should be financed by equity or debt is generally not tax-driven. See, e.g., Oliver R. Hoor & Keith O'Donell, *BEPS Action 4: When Theory Meets Practice*, 78 Tax Notes Int'l 643, 644 (2015).

11 For a general reference on the discussion about debt and equity, see e.g., Wolfgang Schön et. al., *Eigenkapital und Fremdkapital* (Springer, Berlin 2013). See also, Wolfgang Schön, *The Distinct Equity of the Debt-Equity Distinction,* 66 Bull. Intl. Taxn. 9 (2012); Wolfgang Schön et al., *Debt and Equity in Domestic and International Tax Law–A Comparative Policy* Analysis, 2 British Tax Rev. 146 (2014).

12 Article 3 of the Proposal for a Directive, supra n. 1.

13 Norbert Herzig, Uwe Lochmann & Bernhard Liekenbrock, *Impact Study of the New German Interest Capping Rule*, 36 Intertax 577, 578 (2008).

14 §15 sentence 1 No. 3 of the German Corporate Income Tax Code (*Körperschaftsteuergesetz*).

15 Articles 16, 63a) of the Spanish Corporate Income Tax Code (*Ley del Impuesto sobre Sociedades*).

16 Klaus Peter Knöller, *The Efficacy of Thin Capitalization Rules and Their Barriers: An Analysis from the UK and German Perspective*, 39 Intertax 317, 318 (2011).

labelled as an adequate anti-avoidance measure.[17] Accordingly, if the rule is labelled as an anti-avoidance measure, it must be considered that *juris et de jure* presumptions have always been held to be disproportionate by the Court of Justice of the European Union (CJEU) in this context.[18] In addition, the proposed interest limitation rule is clearly disproportionate as it applies to both group and non-group companies. While base erosion can easily arise in cases of group companies, its likelihood decreases in a non-group companies' context demonstrating the disproportion of the rule. Needless to say, this rule may cause double taxation when the interest earned is taxable at creditor level, while the interest expense may not be fully deductible at borrower level.[19]

The future redrafting of the Proposal should be made considering an interest limitation rule adopting a more suitable criterion that takes into account specific facts and circumstances, e.g., an arm's length principle (ALP) criterion.[20] It is evident that the implementation costs and complexity of the ALP can be much higher than using a fixed criterion,[21] but both measures may also be implemented together by introducing the ALP measure as a carve-out clause that the taxpayer could resort to by proving that comparable entities within the same economic circumstances maintain the same debt-equity ratio as the entity under scrutiny.[22] By adopting this solution, both the advantages of fixed criteria and the proportionality inherent to the ALP would be present.[23]

2.1.3 *Ability to Pay Principle and the Interest Limitation Rule*

Finally, the interest limitation rule poses certain problems from a legal perspective considering the ability to pay principle, i.e. taxation of income on a net basis taking into account both gross income and expenses related to the business at hand.[24] In this regard, it is worth mentioning a recent decision from 14 October 2015[25] rendered by the German Federal Fiscal Court (*Bundesfinanzhof*) with regard to the German interest limitation rule (*Zinsschranke*).[26] The judges expressed serious doubts as to whether the Zinsschranke would be compatible with the principle of equal treatment enshrined in Article 3§1 of the German Constitution (*Grundgesetz*), from which the ability to pay principle is derived. For that reason, the *Bundesfinanzhof* decided to refer this question to the German Constitutional Court (*Bundesverfassungsgerichtshof*), which is the competent court in Germany to deal with the constitutionality of laws.[27]

According to the *Bundesfinanzhof*, the Zinsschranke, by limiting the deduction of interests, which should normally be treated as business expenses, violates the objective net principle (*objektives Nettoprinzip*), which means that tax payers have to be taxed on the basis of their net profits. The fact that a carry forward of non-deductible interests is allowed should be regarded as irrelevant considering that German income taxes are designed to be triggered on a yearly periodical basis and the *objective net principle* should be referred to this time frame period.[28] It should be noted that, although the legislator might have a wide margin of appreciation when designing the tax system, he is also bound by the principle of consistent legislation (*Gebot der Folgerichtigkeit*), which requires, among others, to implement the ability to pay principle in a consistent way, unless a sufficiently grounded justification is provided.[29] The Court dismissed in particular the following three justification grounds: (1) the need to strengthen the equity base of German enterprises;[30]

[17] Hence, the authors would like to stress that base erosion or profit shifting is not the same as tax avoidance or tax abuse. These concepts may be interrelated in some points but are certainly not alike in others.

[18] Johanna Hey, *Base Erosion and Profit Shifting and Interest Expenditure*, 68 Bull. Intrl. Taxation 332, 340 (2014).

[19] Hardy Fischer & Allit Lohbeck, *Germany Report* in *IFA Cahiers, The Debt-Equity Conundrum*, 307, 319 (IFA Cahiers de Droit Fiscal International, Vol. 97b, 2012). This result may arise mainly due to failure of bilateral cooperation. See Helmut Loukota, *Internationale Probleme mit der deutschen Zinsschranke*, 18 Steuer und Wirtschaft International 105, 106 (2008). See also, Hey, supra n. 18, at 335.

[20] Interestingly, the design of Art. 4h of the German Corporate Income Tax Code (the direct influence of the norm contained in the proposal for a Directive) also had the same critic of not being linked to the ALP. See Andreas Fross, *Earning Stripping and Thin Cap Rules: Maintaining an Arm's Length Distance*, 53 Eur. Taxn. 10, 509 (2013).

[21] For concerns on ALP compliance costs, see Dale Wickman; Charles Kerester (1992), *New Directions Needed for Solution of the Transfer Pricing Tax Puzzle*, 5 Tax Notes Intrl. 399, 413. Hubert Hamaekers, *Transfer Pricing and the Arm's Length Principle: History, Present Situation, Future*, 16 Skatterett 286, 297–298. Yariv Brauner, *Transfer Pricing in BEPS. First Round – Business Interests Win (But, Not in Knock-Out)*, 43 Intertax 72, 72.

[22] As an example from outside the EU, China poses such a carve-out rule by which the taxpayer can prove that even under an excess of ratio 2:1 (debt-capital), the debt is considered arm's length. In such a case, the Chinese thin caps rules are not applied. See S. (Shiqi) Ma, China (People's Rep.) – Corporate Taxation s. 10. Country Analyses IBFD (accessed 11 Mar. 2016). See also, Roberta Assad, *The New Brazilian Thin Capitalization Rules and How the Other BRICs Approach the Subject*, 64 Bull. Intl. Taxn. 6, 339 (2010).

[23] Hey, supra n. 18 at 338. The ALP as a proportionality criterion within tax avoidance measures was contemplated in Judgment in *Test Claimants* in *Thin Cap*, C-524/04, EU:C:2007:161, paragraph 87; Judgment in *SGI*, C-311/08, EU:C:2010:26, para. 71.

[24] Knöller, *supra* n. 16, at 329.

[25] Bundesfinanzhof, decision of 14 Oct. 2015, I R 20/15 (hereinafter: 'the decision').

[26] §4h Einkommensteuergesetz (German Income Tax Code).

[27] The constitutionality of the Zinsschranke had already been discussed extensively in German doctrine. See Moritz Glahe, *Einkünftekorrektur zwischen verbundenen Unternehmen: Vereinbarkeit der deutschen Verrechnungspreisvorschriften und der Zinsschranke mit Europa- und Verfassungsrecht* (Dr Otto Schmidt 2012); Markus München, *Die Zinsschranke – eine verfassungs-, europa- und abkommensrechtliche Würdigung* (Peter Lang 2010); Christian Marquart & Alexander Jehlin, *Zu den verfassungsrechtlichen Grenzen einer 'Steuerinnovation' Zugleich Anmerkung zum Beschluss des BFH vom 13. 3. 2012, I B 111/11*, DStR 2301 (2013).

[28] Paragraph 17 et seq. of the decision.

[29] Paragraph 14 of the decision.

[30] Paragraph 33 et seq.

(2) the need to safeguard the German tax base;[31] and (3) an anti-avoidance ground.[32]

2.2 Exit taxation

In order to prevent EU taxpayers from moving their tax residence and/or assets to another jurisdiction without paying taxes on unrealized gains, the Proposal for a Directive establishes that Member States shall impose an exit tax upon cross-border transfers.[33] Beyond a technical analysis of Article 5 of the Proposal, the authors would like to stress some general issues regarding the implementation of this measure, especially the imposition of an exit tax without restrictions in case that third States are involved and the imperfect attempt to counteract double non-taxation as presented in the norm.

2.2.1 *Is Imposing an Immediate Exit Tax Always Justified in Third-State Scenarios?*

One of the striking features of Article 5 of the Proposal for a Directive is the different treatment of intra-EU/EEA transfers and those towards third States. Regarding intra-EU transfers, the Proposal for a Directive allows taxpayers to defer the payment by paying the instalments over a term of at least five years. In this case, Member States may, under certain circumstances, charge interest in accordance with the applicable national legislation, and may also request a bank guarantee.[34] Regarding third-State scenarios, Member States shall foresee an immediate recovery of the tax on unrealized gains and therefore treat these transactions in a less favourable way compared to intra-EU transfers. In accordance to settled case law of the CJEU, an exit tax constitutes an infringement of the freedom of establishment.[35] The CJEU however stated in its DMC case that exit taxes may also infringe the free movement of capital, and therefore, a freedom applicable to third-State residents and transactions involving third countries.[36]

An unequal treatment caused by exit taxes in intra-EU situations can be justified based on the balanced allocation of taxing rights.[37] Vis-à-vis third-state residents, it could also be invoked for the need to ensure effective fiscal supervision. Although the CJEU tends to apply the justification and proportionality test in a less stringent manner when it relates to the violation of third-State resident's rights, some scholars have raised the legitimate question whether the immediate recovery of an exit tax in third-country scenarios is in any event the most appropriate means to ensure effective fiscal supervision.[38] The Proposal at hand simply ignores this issue by imposing an immediate exit tax in all third-State scenarios.

2.2.2 *Differences in Valuation of Assets and Double Taxation*

Cross-border transfers of assets may lead to double taxation where both the State of departure and destination apply different asset valuation methods.[39] The Commission and Council have already identified this problem in the past and urged the Member States to better coordinate their national rules on exit taxes by obliging the inbound Member State to accept the value established by the Member State of origin at the moment of transfer as the starting value of the asset.[40]

By obliging the Member State of destination to accept the market value established by the other Member State, the Proposal for a Directive intends to overcome, among others, the problem of double taxation. However, one should bear in mind that Article 5(5) of the Proposal applies only to intra-EU transfers, and does not offer a solution for transfers from EEA or third state countries.

[31] Paragraphs 37–38.

[32] Paragraph 47 et seq. Should the Member States decide to adopt the Proposal for a Directive and should at the same time the German Constitutional Court declare the German Zinsschranke as being contrary to the ability to pay principle, Germany will have to face the dilemma of being obliged to transpose a rule into its domestic law that deviates from its Constitution, or face an infringement procedure.

[33] The Proposal for a Directive basically establishes three situations where the outbound Member State shall impose an exit tax on the difference between the book and market value: (1) in cases of cross-border transfers of assets between the head office and its permanent establishment (PE) or vice versa; (2) in the event of a cross-border transfer of assets between PEs, and (3) on the transfer of residency (except PE assets, which remain connected with a PE in the State of departure) or a PE. Accordingly, the Proposal for a Directive establishes specific rules regarding the tax recovery and intra-EU/EEA transfers. See Art. 5 of the Proposal for a Directive, supra n. 1.

[34] Within legal doctrine, it is a moot point whether the application of interest charges and the requirement of a guarantee are in line with the fundamental freedoms. See Michael Tell, *Exit Taxation within the European Union/European Economic Area – After Commission v. Denmark* (C-261/11) 54 Eur. Taxn. 2/3, s. 4.2. et seq. (2014); Paloma Schwarz, *La transformation transfrontalière des sociétés dans l'Union européenne*, Journal de droit européen 208, 145 (2014).

[35] Judgment in *National Grid Indus*, C-371/10, EU:C:2011:785, paras 35 et seq.; Judgment in *Commission v. Netherlands*, C- 301/11, EU:C:2013:47, para. 16 et seq.; Judgment in *Commission v. Spain*, C- 64/11, EU:C:2013:264, paras 26 et seq.; Judgment in *Commission v. Denmark*, C- 261/11, EU:C:2013:480, paras 25 et seq.; Judgment in *Verder LabTec*, C- 657/13, EU:C:2015:331, paras 32 et seq.

[36] Judgment in *DMC*, C- 164/12, EU:C:2014:20, paras 28 et seq.

[37] Judgment in *National Grid Indus*, infra n. 39, at para. 46.

[38] Erik Pinetz & Erich Schaffer, *Exit Taxation in Third-Country Situations*, 54 Eur. Taxn. 10, s. 3.2.2. (2014).

[39] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee – Exit taxation and the need for coordination of Member States' tax policies, COM(2006) 0825 final, at 7. See also Erik Rõder, *Co-ordination of Corporate Exit Taxation in the Internal Market and Beyond*, British Tax Rev. 574, 584 et seqq. (2014).

[40] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee – Exit taxation and the need for coordination, *supra* n. 37, s. C.

Therefore, where a transfer from an EEA or third state occurs, it could still lead to double taxation.

2.2.3 *Presumed Minimum Standards*

As indicated above, the Proposal intends to establish a minimum level of protection for Member States' corporate tax systems.[41] Therefore, it seems that each individual Member State might decide to implement stricter anti-avoidance rules than those contained in the Proposal. By taking the example of Article 7(3) of the exit tax provision, the authors would like to highlight that this is not an adequate conclusion.

According to Article 7(3), taxpayers may be required to provide a guarantee as a condition for deferring the payment of an exit tax if there is 'a demonstrable and actual risk of non-recovery'. Assuming that Article 7(3) would be understood as a minimum standard, Member States could also decide to require a bank guarantee in cases where there is not such a demonstrable and actual risk of non-recovery. However, such an interpretation would clearly conflict with the CJEU's statement in DMC where it had explicitly stated that the requirement of a bank guarantee constitutes a restriction of the fundamental freedoms, which cannot be justified 'without prior assessment of the risk of non-recovery'.[42] Therefore, as it can be noted from the example of Article 7(3), the European Commission seems to settle on a 'maximum standard' instead of a minimum one, with the consequences that it will not be possible for EU Member States to adopt more stringent rules.

2.3 Switch-Over Clause

The switch-over clause is one of the most controversial provisions in the Proposal for a Directive not only because it contradicts the historic trend towards the exemption system in continental European countries,[43] but also because of its dubious effectiveness as an anti-avoidance measure.[44]

Article 6 establishes a switch-over clause that allows a Member State not to apply the exemption system to a taxpayer where the taxpayer receives a profit distribution[45] or proceeds from a disposal of shares held in an entity situated in a third country which is regarded as a 'low tax' country.[46] Instead, the profits or proceeds would be taxed in the EU Member State, which would grant a deduction for taxes paid in the third country.[47] This rule also applies to low taxed Permanent Establishment (PE) profits from third countries.[48]

In an intend to set up 'adequate' corporate tax behaviours, the proposed switch-over clause not only challenges some tax policy features used traditionally by EU Member States, such as the use of the exemption method to relieve double taxation, but it also conflicts with the tax treaties in force establishing a generalized treaty override clause. All these matters are analysed as follows.

2.3.1 *Relief of Double Taxation and Competitiveness in the EU*

The exemption method has been traditionally the preferred method to relieve double taxation in continental EU Member States.[49] Its main characteristic is that it allows a Member State to exempt unilaterally foreign income received, regardless of whether that income was subject to tax or not in another country. In

[41] Proposal for a Directive, supra n. 1, at 5.

[42] Judgment in *DMC*, supra n. 36, at para. 67.

[43] Unlike the United Kingdom, most of the continental European countries use the exemption method to relief double taxation because it fits better the objectives of the internal market. See, e.g., Wolfgang Schön, *Tax Competition in Europe–The National Perspective*, 42 European Taxation 12, 495 (2002). See also, Marjaana Helminen, *The Problem of Double Non-Taxation in the European Union – To What Extent Could This Be Resolved through a Multilateral EU Tax Treaty Based on the Nordic Convention?*, 53 Eur. Taxn. 7, 309 (2013). The primacy of the exemption system can also be seen in the European Commission's proposal for a CCCTB. This proposal foresees unconditional exemption for distributions coming from companies outside the group, with the switch-over clause and a CFC rule only applying to distributions from subsidiaries that are resident outside the European Union. See Georg Kofler, *Indirect Credit versus Exemption: Double Taxation Relief for Intercompany Distributions*, 66 Bull. Intl. Taxn. 2, 89 (2012). See also, Cerioni, supra n. 5 and Barenfeld, supra n. 5.

[44] The same critic is stressed by the authors with respect to the interest limitation rule of Art. 4 and hybrid mismatches of Article 10 of the Proposal for a Directive. *Supra* s. 2.1. and *infra* s. 2.6.

[45] The reference to 'profits distributions' (or 'distributed profits') is very important in the context of hybrid financial instruments in Europe. For example, in Ireland a profit-based compensation (e.g., remuneration on participating loans) is a strong indication of equity. This is to say, they will be considered as a profit distribution and exempted in the EU in application of the Parent-Subsidiary Directive (2011/). See Christian Kahlenberg & Agniezka Kopec, *Hybrid Mismatch Arrangements–A Myth or a Problem that Still Exists?*, 8 World Tax J. 1, 12 (2016). Unlike the concept 'profit distributions' is not defined anywhere and it can conflict with the concept of 'dividends' under Art. 10 of the OECD Model Tax Convention, it is a generalized opinion by scholars that the concept of profit distributions is an EU concept and it must be autonomously interpreted by the CJEU. See e.g., Cecile Brokelind, *Swedish Supreme Administrative Court Rejects Reference to ECJ Regarding Application of EC Parent-Subsidiary Directive*, 45 Eur. Taxn. 8 (2005). See also, e.g., Georg Kofler, *Mutter-Tochter-Richtlinie – Kommentar*, Lexis Nexis (2011) and Ton Stevens & Gijs. Fibbe, *Taxation of Hybrid Entities under the Parent-Subsidiary Directive: The Example of the Netherlands*, 20 EC Tax Review 5 (2011). For the ECJ, the term 'dividends' in Art. 10 does not prescribe any reference to the term 'profits distributions' in the EU context. See Judgment in *Ferrero v. C. SpA v. Agenzia delle Entrate – Ufficio di Alba and General Beverage Europe BV v. Agenzia delle Entrate – Ufficio di Torino 1*, C-338/08 and 339/08 EU:C:2010:364, para. 27.

[46] Article 6(1) of the Proposal for a Directive, supra n. 1.

[47] 'Low tax' means that the profits or the proceeds from the sale of shares are subject to a statutory corporate tax rate of less than 40% of the statutory corporate tax rate that would have been charged in the Member State where the taxpayer receiving the profits or proceeds is located. *Id.*

[48] Article 6 of the EU Anti-Avoidance Directive clearly states that a switch-over clause will not apply to two types of losses. First, losses incurred by the PE of a resident taxpayer situated in a third country. Second, losses from the disposal of shares in an entity which is tax resident in a third country. *Id.*

[49] Supra n. 44.

fact, it is of the essence of any exemption system not to rely on the taxation of the other country.[50] This is of special importance in the case of exempting profit distributions derived from foreign subsidiaries or profit transfer from PEs.[51]

The preference to use the exemption method instead of the credit method in Europe has been largely discussed by important tax scholars in the past,[52] and having in mind tax neutrality as a widely accepted economic principle to define a tax system, it is more than well recognized that the exemption system fits better the aims of competitiveness of domestic tax systems and simplicity among Member States in the EU.[53] Therefore, deviating from the exemption method simply implies to punish EU companies who are willing to grow a business in another jurisdiction without a reasonable justification,[54] affecting also their competitiveness abroad.[55] In the short-middle term, Parent-headquarters in the EU could simply decide to emigrate either to another Member State with lower statutory corporate tax rates[56] or to simply opt for leaving the EU. Whatever route is taken, the final result may be a decrease in tax revenues and perhaps even a detriment to the Member States employment statistics.[57]

2.3.2 *Patterns of 'Adequate' Statutory Corporate Tax Rates*

As noted, the key element to trigger the application of Article 6 is that a subsidiary (or a PE) situated in a third country in which the statutory tax rate applicable to the profits of that subsidiary (or PE) is less than 40% of the statutory tax rate which would be applicable in the Member State in which the parent company is located.[58]

The use of statutory tax rates as a parameter to determine the application of the rule lacks of reasonable justifications. In fact, one should immediately question the evident contradiction in the design of a Proposal for a Directive that contains a switch-over clause that claims for the use of statutory tax rates, while the same Proposal contains a CFC rule comparing effective tax rates between the controlling and controlled entity.[59] Is it more recommendable one than the other? At least a minimum of coherence should be expected in a Proposal for a Directive. Beyond this criticism, perhaps the altruistic intention to set up certain limits on what a proper corporate tax rate ought to be is the final reason to set up a rule based on the statutory corporate tax rate.[60] However, even in such a case one could rightly question: what has that intention to be with anti-avoidance measures?

The authors do not see any connection between establishing patterns of corporate tax rate and combating tax avoidance. Indeed, other factors such as the activities developed in the third countries, the presence in terms of number of employees, or the level of activities measured with the investment made, as considered in the past,[61] are completely disregarded under the Proposal. Needless to say, the total exclusion of factors more connected to the combat of abuse such as the

[50] In contrast, e.g., the foreign tax credit is granted in a dollar-by-dollar basis. This is to say, no credit is allowed when there is no income tax paid in the source country. For a general comparison between the credit and exemption methods as international mechanisms used to relief double taxation see, e.g., Guglielmo Maisto, *Credit versus Exemption under Domestic Tax Law and Treaties*, in *Tax Treaties: Building Bridges between Law and Economics* s. 2. (Michael Lang et al. eds, IBFD 2010).

[51] For example, Luxembourg adopts the exemption method for the elimination of double taxation where a Luxembourg enterprise derives profits from a foreign PE. See Oliver R. Hoor, *The Tax Treatment of Permanent Establishments*, 54 Eur. Taxn. 7 (2014). See also, Art. 22 of the Spanish Income Tax Law (Ley de Impuesto de Sociedades).

[52] See, e.g., John F. Avery Jones, Avoiding Double Taxation: Credit versus Exemption – The Origins, 66 Bull. Intl. Taxn. 2 (2012).

[53] As explained by Schön: 'From an economic standpoint, both features of "tax neutrality" [capital import and capital export neutrality] have their merits. It is a long-standing tradition to which many European states have submitted and it is also sound fiscal policy to set up a tax system according to the ideal of "capital import neutrality"'. Schön, *supra* n. 44.

[54] Considering the negative impact of a switch-over clause, Weber proposes to eliminate it arguing that other provisions, such as CFC rules (Art. 8 of the Proposal for an EU Anti-Avoidance Directive), would be more effective to tackle passive low-taxed entities. See Dennis Weber, *Taxing Low-Tax Non-EU Income: Think Twice*, www.kluwertaxblog.com (acceded on 11 Feb. 2016). In contrast, and analysing the phenomenon of double non-taxation, Helminen proposes a switch-over clause which would be applicable in situations in which the source State does not tax the income concerned or the exemption method could be combined with a subject-to-tax clause. See Helminen, supra n. 44, at 309. Accordingly, some Member States (e.g., Germany) that have opted in the past for the unilateral inclusion of a switch-over clause and a subject-to-tax clause in its domestic legislation in order to fight against tax avoidance. However, its application has not been exempted from criticism, mostly when considering its compatibility with tax treaties. See, e.g. Richard Resch, *The New German Unilateral Switch-Over and Subject-to-Tax Rule*, 47 European Taxation 10 (2007).

[55] This is more evident if we compare a group of US investors and a group of EU investors willing to invest in a country with specific tax incentives. The formers will certainly be in a more advantageous situation after the implementation of the proposal, considering they will have some tools not available for their EU competitors in those countries (e.g., check-the-box and cost sharing arrangements), and also because some crucial rules in the proposal will not affect them at all. See *infra* s. 6. The situation today is different. If a country is offering an incentive (e.g., a tax holiday) and some EU companies decide to invest in that country, they benefit from the tax holiday and subsequently from the exemption system when the dividends are repatriated. Conversely, US investors cannot really benefit from the tax holiday, because the United States uses a tax credit system and does not accept the inclusion of tax sparing clauses in its tax treaties.

[56] Ireland, e.g., with a general statutory Corporate Tax Rate of 12.5% (for 2003 onwards) would be certainly an attractive option. See s. 21 of the Taxes Consolidation Act 1997, Notes for Guidance (Finance Act 2015 Edition), http://www.revenue.ie/en/practitioner/law/notes-for-guidance/tca/ (as updated to the Finance Act 2015).

[57] Indeed, the consequences of a massive migration can be disastrous considering these companies are in charge of creating jobs. Weber, supra n. 55.

[58] *Supra* s. 3.1.

[59] *Infra* s. 5.

[60] This clearly affects the sovereignty of the Member States to design their own tax systems granted under EU Law.

[61] See, e.g., OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, 34–35 (OECD Publishing, Paris).

distinction between non-genuine and legitimate transactions, are a demonstration that the purpose of the norm seems to be more connected with the simple generation of revenues.[62]

2.3.3 *The Switch-Over Clause and the BEPS Project*

However, the switch-over is not only exogenous to the EU market, it was also excluded from the OECD BEPS proposal, at least in literal terms.[63] The above makes sense considering that the BEPS Project is based on the premise that income should be taxed where the profits are sourced or where the value is created.[64] Contrary to the BEPS Project of the OECD, the Proposal for a Directive states that Member States, under certain conditions, must tax the distribution of profits received from third low-tax countries, contradicting also the tax policy behind the exemption system.[65]

2.3.4 *Switch-Over and Treaty Override*

Finally, it is important to highlight that due to the prevalence of EU law over tax treaty commitments,[66] the enactment of a switch-over clause could imply a massive treaty override within the whole EU tax treaty network. Unilateral action by the EU in this sense will impact DTCs balance on the paramount issue of the double taxation relief method to be applied.

2.4 General Anti-avoidance Rule (GAAR)

In order to target abusive tax practices not captured by a specific anti-avoidance rule, the Proposal for a Directive requires Member States to implement a general anti-abuse rule (GAAR) reflecting the artificiality test developed by the CJEU.[67] When calculating the corporate tax liability, Member States shall disregard non-genuine arrangements. Likewise, the Proposal leaves to the Member States the decision on the computation of tax liability, which must be performed by reference to 'economic substance'.[68]

2.4.1 *General EU Member States' Obligation to Fight Abusive tax Practices*

There is no general principle in EU law that obliges Member States to combat abusive practices in the field of direct taxation.[69] One could even go a step further and argue that the CJEU has even put to rest the arguments that there is a GAAR for the purposes non-harmonized taxes or that there should be one.[70] Accordingly, secondary EU law acts in direct tax matters authorize (but not oblige) Member States to apply national anti-abuse rules within the scope of the respective directive.[71] Nevertheless, the recent amendment of the Parent-Subsidiary Directive and the Proposal for a Directive seems to go in the opposite direction by establishing a common anti-abuse rule.[72]

Whereas the amendment to the Parent-Subsidiary Directive aims to prevent misuse and impose greater consistency when applying the Directive,[73] the Proposal at hand clearly takes a step further by intending to combat any abusive tax practices not covered by a specific anti-abuse rule.[74] This is underlined by the fact that the GAAR is aimed to apply uniformly to both

[62] A similar conclusion can be found regarding the interest limitation rule and the provision on exit tax. *Supra* ss 3.1 and 3.2.

[63] Although this argument could be argued in contrast considering, e.g. the recommendation of a defensive rule under the BEPS Action 2 to counteract hybrid mismatches. In fact, this rule obliges a country to deny an exemption in the receiving country if the item of income received was deducted in the payor country. The final result could be exactly the same one obtained under an explicit switch-over clause. For the explanation about the defensive rule on hybrids, see *infra* s. 6.1.

[64] OECD (2013), supra n. 3. The vague notion of 'value creation' has been criticized by important scholars due to its lack of consistency with the traditional application of the arm's length standard without any explicit renunciation of the old belief. This contradictory approach can also be noted in the explicit rejection by the OECD of a formulary apportionment or a generalized profit split method that replaces the arm's length. See W. Schön, *Transfer Pricing Issues of BEPS in the Light of the EU Law*, 3 British Tax Rev. 417, 419–420 (2015). Accordingly, Brauner argues that the determination of where is the 'value created' is not an easy task when he says: '[W]hen an intangible is completely designed and perfected in one country but is solely exploited in a second country, where is the value created– in the first or in the second? If in both – how to split the value creation between the two jurisdiction?'. See Yariv Brauner, *BEPS: An Interim Evaluation*, 6 World Tax J., 32 (2014).

[65] *Supra* s. 3.1.

[66] This is due to the principle of EU Law primacy, settled by the ECJ in its landmark Judgment in *Costa v. E.N.E.L.*, C-6/64, EU:C:1964:66. All in all, the authors must introduce a *caveat:* due to Art. 351 of the (TFEU), Tax Treaties signed before 1 Jan. 1958 would prevail over EU Law.

[67] Judgment in *Cadbury Schweppes and Cadbury Schweppes Overseas*, C-196/04, EU:C:2006:544, para. 51; Judgment in *Test Claimants in the Thin Cap Group Litigation*, supra n. 23, paras 72 et seq.

[68] Article 7(3) of the Proposal for a Directive, supra n. 1.

[69] Judgment in *3M Italia*, C-417/10, EU:C:2012:184, para. 32. See also, Luc De Broe, *International Tax Planning and Prevention of Abuse,* s. 2.3 (IBFD 2007); Dennis Weber, *Abuse of Law in the Context of Indirect Taxation. Why We Need the Subjective Intention Test, When is Combating Abuse an Obligation and other Comments,* in *Prohibition of Abuse of Law: A New General Principle of EU Law?*, 400 (Rita de la Feria & S. Vogenauer eds., Hart Publishing 2011); Michael Lang, *Cadbury Schweppes' Line of Case Law from the Member States' Perspective*, in *Prohibition of Abuse of Law: A New General Principle of EU Law?*, 451 (R. de la Feria & S. Vogenauer eds., Hart Publishing 2011).

[70] Christiana Panayi, *European Union Corporate Tax Law*, 337 et seq. (Cambridge University Press 2013). See also, *Advanced Issues in International and European Tax Law*, 166 (Hart Publishing 2016).

[71] Article 5 of Council Directive 2003/49/EC of 3 Jun. 2003 on a common taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L157 (2003), EU Law IBFD; Art. 15 of Council Directive 2009/133/EC of 19 Oct. 2009 on the Common System of Taxation Applicable to Mergers, Divisions, Partial Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States and to the Transfer of the Registered Office of an SE or SCE between Member States (Codified Version), OJ L310 (2009), EU Law IBFD.

[72] Council Directive 2015/121 of 27 January amending Directive 2011/96/EU on the Common System of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L21/1 (2015), EU Law IBFD (Amending Directive).

[73] Recitals 4-5 of the Parent-Subsidiary Directive (2015).

[74] Proposal for a Directive, supra n. 1, at 9.

domestic and cross-border situations, including vis-à-vis third countries. It shall also impact situations where EU law is not applicable.[75]

2.4.2 *An Unsuccessful Attempt to Establish a Uniform GAAR within the EU*

Article 7 of the Proposal for an Anti-avoidance Directive requires: (a) a non-genuine arrangement or a series thereof, which (b) must have been carried out with the essential purpose of obtaining a tax advantage, and (c) this tax advantage obtained must defeat the purpose of the otherwise applicable tax provisions.[76] The term 'arrangement' is not defined in the Proposal for an Anti-avoidance Directive, as is the case of the Parent-Subsidiary Directive. However, from the Commission's GAAR Recommendation,[77] one may arrive to the conclusion that the Commission favours an extensive interpretation of this term. Furthermore, in order to qualify as abusive tax practice, an arrangement needs to be regarded as non-genuine, i.e. 'not put into place for valid commercial reasons which reflect economic reality'.[78]

Although, one may wonder why the Commission deviates from the wording of its GAAR Recommendation and the one used by the CJEU in cases dealing with anti-abuse rules by not using the term 'artificiality',[79] it becomes clear from the recitals of the Proposal for a Directive that the Commission is using these terms in an interchangeable fashion.

In order to identify an abusive tax practice, Member States shall rely on a test containing both subjective and objective elements. As to the subjective test, the provision requires, in accordance with the wording of the Commission's GAAR Recommendation, the arrangement to be 'carried out for the essential purpose of obtaining a tax advantage that defeats the object or purpose of the otherwise applicable tax provisions'.[80] In contrast to the GAAR contained in the Parent-Subsidiary Directive and the principal purpose test (hereinafter 'PPT') contained in the BEPS Action 6, the purpose of obtaining the tax advantage clearly needs to be the taxpayer's main purpose and not simply 'one of the main purposes'. A similar wording can be found in the anti-abuse provisions of the Merger and Interest and Royalties Directives, which use the terminology '*principal objective*'. It is interesting to note in this regard that Article 80(1) of the original CCCTB proposal[81] containing a GAAR initially also used the notion of 'sole purpose' and was later modified into 'mainly for the purpose'.[82] It should be welcomed that the Commission decided to opt for an 'essential purpose test' instead of a 'one of the main purpose test' considering that in legal literature scholars have argued that the latter test would clearly deviate from the jurisprudence of the CJEU.[83]

As far as the intended tax advantage is concerned, it is necessary analysing whether this advantage 'defeats the object or purpose of the otherwise applicable tax provisions'.[84] The wording of the Proposal at hand differs considerably from the one under the Parent-Subsidiary Directive. Whereas the test within the GAAR of the Parent-Subsidiary Directive requires an investigation into the motives of the Directive itself and is aimed to analyse whether the intent of the EU legislator would be frustrated if the tax advantage were granted under the given circumstances,[85] the GAAR of the Proposal for an Anti-avoidance Directive clearly refers to Member States' national tax legislation. In this sense, it is important to bear in mind that frequently, corporate tax rules do not have any noticeable purpose other than raising revenue. The lack of a purposive element attached to a given rule implies that the analysis

[75] *Ibid.*, recital 9.

[76] The proposal bears a resemblance to the one contained in the Parent-Subsidiary Directive, also drawing on the Commission's GAAR Recommendation. See Commission Recommendation of 6 Dec. 2012 on aggressive tax planning, C(2012) 8806 final (hereinafter, 'Commission's GAAR Recommendation'). Moreover and similar to the GAAR of the Parent-Subsidiary Directive, the GAAR of the Proposal for a Directive and the Principle Purpose Test in the OECD Action 6 show similarities.

[77] The Commission's GAAR Recommendation defines an arrangement as 'any transaction, scheme, action, operation, agreement, grant, understanding, promise, undertaking or event'. *Ibid.* at 4.

[78] Article 7(2) of the Proposal for a Directive, supra n. 1.

[79] On the notion of artificiality see, e.g., Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee – The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries, COM(2007) 785 final, 3 et seq. See also, De Broe, supra n. 70, at s. 2.2.1.2; Adolfo Martín Jiménez, *Towards a Homogenous Theory of Abuse in EU (Direct) Tax Law*, 66 Bull. Intl. Taxn. 4/5 (2012), Journals IBFD; Dennis Weber, *Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ – Part 1*, 53 Eur. Taxn. 6, ss 2.6 et seq. (2013), and Koen Lenaerts, *The Concept of 'Abuse of Law' in the Case Law of the European Court of Justice on Direct Taxation*, Maastricht J. European and Comparative Law 3, (2015).

[80] See Art. 7(1) of the Proposal for a Directive, supra n. 1.

[81] See Proposal for a Council Directive on a Common Consolidated Tax Base (CCCTB), COM (2011) 121/4 (hereinafter, 'CCCTB Proposal').

[82] Amendment n° 28 to the Art. 80(1), European Parliament legislative resolution of 19 Apr. 2012 on the CCCTB proposal. On the GAAR of the CCCTB Proposal see, e.g., Silvia Velarde Aramayo, *A Common GAAR to Protect Harmonized Corporate Tax Base: More Chaos in the Labyrinth*, EC Tax Review 4 (2016); Michael Lang, *European Union – The General Anti-Abuse Rule of Article 80 of the Draft Proposal for a Council Directive on a Common Consolidated Corporate Tax Base*, 51 Eur. Taxn. 223, (2011).

[83] See Dennis Weber, *The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive: Background, Impact, Applicability, Purpose and Effect*, 44 Intertax 98, 110 (2016). In the context of BEPS Action 6, it has been argued that the use of subjective criteria based on intentions should be regarded as undesirable, because it would be contrary to the ability to pay principle that two taxpayers in identical objective circumstances would be taxed differently only because of their varying motives. See Michael Lang, *BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties*, 74 Tax Notes International 660 (2014); Andrés Báez, *GAARs and Treaties. From the Guiding principle to the Principal Purpose Test. What have we gained from BEPS Action 6?* 6 et seq. (2016), available at www.ssrn.com.

[84] Article 7(1) of the Proposal for a Directive, supra n. 1.

[85] Filip Debelva & Joris Luts, *The General Anti-abuse Rule of the Parent-Subsidiary Directive*, 55 Eur. Taxn. 6, s. 2.4. (2015).

posed in the GAAR under scrutiny would become senseless in these cases, unless one reaches the unsound conclusion that to best comply with the purpose of these rules, i.e., raising revenue, a taxpayer should adopt the most burdensome alternative to conduct business.[86]

Likewise, with respect to the computation of the tax liability, the Proposal refers to national law, although the only precondition is that it shall be calculated by reference to economic substance.[87] In contrast to the PPT, which simply leads to the consequence that treaty benefits are not being given, the GAAR of the Proposal for a Directive seems to offer the possibility of taking further action, possibly re-characterization.[88]

As a result of these references to national law, one may question how the Proposal intends to establish a uniform GAAR within the European Member States. First, Member States already imposing a GAAR may presumably not be deprived of the right to continue using their existing provisions in the usual manner including the degree to which they normally counter abusive tax practices. Second, even if all Member States would decide to adopt a provision adapting as far as possible the wording of the Proposal at hand, there is no consistent concept of abuse in the field of direct taxes within European law respectively among European Member States, on which Member States could rely, and there are still a number of linguistic disparities across the various official languages of the EU, which makes it difficult to elaborate common standards.[89] It is unclear why the Commission is insisting anyhow to implement a GAAR although it is aware of these practical problems.[90]

[86] This striking consequence was named by literature as *cash justice* for obvious reasons. See Wolfgang Schön, *Legalität, Gestaltungsfreiheit und Belastungsgleichheit als Grundlage des Steuerrechts* in *Gestaltungsfreiheit und Gestaltungsmissbrauch im Steuerrecht* 59 et seq. (R. Hüttermann ed., Dr. Otto Schmidt 2010). The very same issue may arise in the context of the proposed PPT. See Báez, supra n. 84, at 12.

[87] Article 7(3) Proposal for an Anti-Avoidance Directive, supra n. 1.

[88] See Panayi, *Advanced Issues in International and European Tax Law,* supra n. 71, at 229.

[89] See, e.g., *Confédération Fiscale Européenne*, *Opinion Statement of the CFE ECJ Task Force on the Concept of Abuse in European Law, Based on the Judgements of the European Court of Justice Delivered in the Field of Tax Law – November 2007,* 48 Eur. Taxn. 1 (2015); Panayi, *Advanced Issues in International and European Tax Law,* supra n. 71, at 162 et seq. For an analysis of the concept of 'tax abuse' see, e.g., F. Alfredo Garcia Prats, *The 'Abuse of Tax Law': Prospects and Analysis in Essays in International and European Tax Law* in Essays in International and European Tax Law, *50-148*, (Gianluigi Bizioli. Jovene Editore ed., 2010). Likewise, to fix a common concept of abuse could help in limiting the action of the Member States in order to establish a strict definition of abuse that can affect legitimate transactions. Supporting the idea of a homogeneous concept of abuse in EU Direct Tax Law see, e.g. Adolfo Martín Jiménez, *Towards a Homogeneous Theory of Abuse in EU (Direct) Tax* Law, 66 Bull. Intl. Taxn. 4/5 (2012).

[90] European Commission, Directorate General Taxation and Custom Union, Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Anti-abuse rules, CCCTB/WP065\doc\en (26 Mar. 2008), at 3.

2.5 Controlled Foreign Companies (CFC) Rule

The Proposal for a Directive contains a CFC rule that obliges the taxpayer to include the non-distributed income of some related entities in its tax base. The requirements of this provision are not new, given that they largely correspond with the CFC rules implemented at a domestic level including, e.g., control and passive income. Nevertheless, the Proposal includes a clear link to wholly artificial or non-genuine arrangements.[91] Finally, the rule establishes a means to avoid double taxation[92] and excludes financial undertakings resident in Member States or in a third country that is part of the EEA, including their PEs.

As follows, the authors describe some potential implications regarding the implementation of the CFC rule.[93]

2.5.1 *The 'Effective Tax Rate' Issue*

A relevant issue that arises from the CFC rule refers to the comparison between the effective tax rates of two Member States (*in concreto* the state where the taxpayer is resident and the state where the CFC is resident). This issue may be problematic considering the effective tax rate varies from entity to entity and from country to country.[94] Accordingly, a multinational entity (MNE) could use entities with a negative taxable income as controlling entities, considering these will have an effective tax rate of 0%. Finally, a clear incentive arises for MNEs to incorporate holding entities in Member States in which the effective tax rate is the lowest possible to channel investments in third countries, as the income of intra-EU CFCs will not be attributed to the corresponding controlling entity unless extra requirements are fulfilled, i.e. unless the establishment

[91] Accordingly, it provides that the income to be included in the taxable base of the controlling entity shall be calculated following the rules of the corporate tax law of the Member State where the taxpayer is resident for tax purposes and in proportion with the entitlement of the taxpayer to receive profits of the entity by virtue of him being a shareholder or a similar relationship. The income shall be included in the tax year in which the tax year of the entity ends. See Art. 8 of the Proposal for a Directive, supra n. 1. For the analysis of the wholly artificial and non-genuine requirement, see *infra* s. 5.3.

[92] Article 9(4) and 9(5) of the Proposal for a Directive, supra n. 1.

[93] Although the authors are aware of the significant debate around the relationship between CFC rules and DTCs, truth is that given the prevalence of EU Law with respect to DTCs, the practical implications of discussing this topic would be close to nil. Kuźniacki, e.g., provides an exhaustive list of sources supporting both the compatibility and non-compatibility of CFC rules with DTCs. See Blazej Kuźniacki, *The Need to Avoid Double Economic Taxation Triggered by CFC Rules under Tax Treaties, and the Way to Achieve it*, 43 Intertax 758, 760 (2015). The OECD supports the former position. See para. 23 of the OECD 2014 Commentaries on Art. 1.

[94] Indeed, the CCCTB proposal contains a CFC rule based on the comparison of the statutory tax rate and not the effective one. See Michael Lang, *The Principle of Territoriality and its Implementation in the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, 13 Florida Tax Rev. 305, 333 (2012).

of the entity is regarded as wholly artificial or to the extent that the entity engages in non-genuine arrangements put in place for the sole purpose of obtaining a tax advantage.

2.5.2 *The 'Wholly Artificial' and 'Non-genuine' Requirements Dilemma: Are They in Conflict?*

In direct tax matters, the 'wholly artificial' requirement was established in the well-known *Cadbury Schweppes* CJEU decision,[95] recently adopted also by the EFTA Court in the Olsen decision.[96] However, this term still lacks clarity, especially with respect to companies managing passive income without need of much substance to function.[97] In spite of the above, the use of this criterion in the context of the Proposal for a Directive does not pose any issue regarding its compatibility with CJEU's case law.

On the other hand, the 'non-genuine' criterion raises several concerns. The definition of what should be considered non-genuine for the purpose of the CFC rule appears extremely puzzling.[98] It appears that the aim of the Proposal for a Directive was to introduce an analysis based on functions, similar to the one proposed by the OECD 2014 Commentaries to Article 7.2. (Authorized OECD Approach, AOA).[99] The use of this technique would imply the performance of an analysis on both the CFC and the controlling entity to ascertain which are the functions developed by each one, so as to attribute risks and, more importantly, the assets that generate the passive income.

The authors believe that the above test is not appropriate. The AOA was designed with the exclusive purpose of applying to PEs, not with respect to CFCs. The prevalence of functions over risks and assets may be explained by the PE fiction, which consists in the attribution of profits within a single enterprise without resorting to legal contracts, because intra-firm relationships are not of a legal nature, i.e. an enterprise cannot conclude binding contracts with itself. The prevalence of functions over risks and assets does not make sense within a CFC rule because it introduces an economic ownership approach alien to a rule that, at the end of the day, does in fact attribute the income obtained by a CFC to a controlling entity without a need to resort to a 'significant people's function' criterion.

Thus, it seems to be that the Proposal for a Directive aims to catch certain types of income in cases where no wholly artificial element exists by allegedly complying with the ALP.[100] The recourse to this standard may be explained by the fact that the CJEU admitted it was a proportionate measure to justify discrimination in cross-border scenarios.[101] Nevertheless, the prevalence of functions over risks and assets cannot be automatically regarded as complying with the ALP, at least not as usually defined by the OECD, the United Nations, the United States or in literature.[102] In the context of the ALP, one should always depart from the analysis of contracts and the conduct of the parties,[103] which means that risks or assets may be allocated contractually and may not depend on performed functions to be assigned to a specific party.[104] Hence, the Proposals' definition of 'non-genuine arrangement' should be regarded as not being in line with CJEU case law, at least not in its current drafting[105]. Moreover, the apostrophe used in 'significant people's functions' puts the emphasis of being significant on the word 'people' rather than on the word 'function', whereby the relevant functions are those performed by 'significant people'. This is a slightly different construction than the one used in the PE

[95] Judgment in *Cadbury Schweppes and Cadbury Schweppes Overseas*, supra n. 68, para. 51. Schön anticipated the use of this criterion, which is often identified as useful to counteract the use of letterbox companies, in a article published five years before the decision of the CJEU. See Wolfgang Schön, *CFC Legislation and European Community Law*, 4 British Tax Rev. 250, 257 (2001).

[96] Judgment of the EFTA Court in *Fred Olsen and Others and Petter Olsen and* Others, Joined Cases E-3/13 and E-20/13, paras 166 et seq.

[97] Ana Paula Dourado, *The Role of CFC Rules in the BEPS Initiative and in the EU*, 3 British Tax Rev. 325, 360 (2015).

[98] According to Art. 8(2): '[. . .] an arrangement or a series thereof shall be regarded as non-genuine to the extent that the entity would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people's functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income'.

[99] Paragraph 15 et seq. of the OECD 2014 Commentaries on Art. 7.

[100] Article 8(2) of the Proposal for a Directive, supra n. 1.

[101] See, e.g., P. Koerver Schmidt, *Are the Danish CFC Rules in Conflict with the Freedom of Establishment? An Analysis of the Danish CFC Regime for Companies in Light of ECJ Case Law*, 54 European Taxation 3, 8 (2014) the CJEU may have been willing to relax the 'wholly artificial' criterion in favour of more relaxed standards, i.e., the ALP one. See also, Dourado, supra n. 98, at 351.

[102] See OECD *2010 Transfer Pricing Guidelines*, paras 1.52–1.54 (2010). Albeit in the BEPS process, the OECD seems to give more prevalence to functions over risks and assets; truth is that contracts are still the point of departure in the comparability analysis, and their content should be respected as long as they properly reflect the arrangements as structured by the parties. See OECD *Aligning Transfer Pricing Outcomes with Value Creation. Actions 8-10: 2015 Final Reports* (2015), para. 1.42-1.50. UN *2013 Manual on Transfer Pricing for Developing Countries*, para. 5.1.6 et seq. See also US Treas. Reg. Sec. 1.482.1(d), and Isabel Verlinden et al., *OECD BEPS Action 9: Evaluating the Devaluation of Risk and Capital*, 24 Transfer Pricing Report 628.

[103] See Heinz-Klaus Kroppen & Axel Eigelshoven, *Landmark Federal Tax Court Decision. No Transfer Pricing Documentation Requirements under Tax Law*, 6 Intrl. Transfer Pricing J. 226, 228 (2001). See also, Eduard Sporken & Hayden Aalvik, *Evidence of Economic Substance is Key to Transfer Pricing Case*, 17 Intrl. Tax Rev. 39, 42 (2006).

[104] Wittendorff warns about hide intentions by the OECD to give more preponderance to functions in the transfer pricing context through revisions to the current notion of transfer pricing enshrined in BEPS Actions 8-10 works. See Jens Wittendorff, *A Look at Cost Sharing in the OECD Discussion Draft*, 78 Tax Notes Int'l 1121, 1123 (2015).

[105] For EU limits to transfer pricing, see Wolfgang Schön, *Transfer Pricing Issues of BEPS in the Light of EU Law*, 3 British Tax Rev. 417 (2015).

context, namely, 'significant people functions'.[106] Thus, the original intent of aligning the concept with the one stated in the AOA approach seems not to be fulfilled. In addition, as the measure in question does not make possible to determine its scope with sufficient precision, it may violate the principle of legal certainty, which is a general principle of EU[107] and CJEU case law, considering in particular the decisions in *SIAT*[108] and *Itelcar*.[109]

Finally, even if an arrangement or a series of arrangements are to be considered non-genuine for purposes of applying the CFC rule, the tax administration must demonstrate the arrangement has been put in place for the essential purpose of obtaining a tax advantage. This purely subjective test gives rise to certain issues, the most relevant one being the difficulty to concretize the meaning of the term 'essential'.[110] Most likely, the result will depend on the domestic set of concepts national judges will have in mind and thus, coordination between Member States may not be reached on this point.

Therefore, the current design of the proposed CFC rule (including a 'non-genuine' requirement) must not only be regarded as contrary to the traditional 'wholly artificial' requirement, but also as a source of confusion and uncertainty for the taxpayers.[111] The authors thus recommend its exclusion in further reconsiderations of the Proposal.

2.6 Hybrid Mismatches

The final measure adopted in the Proposal for a Directive[112] is aimed to counteract the so-called hybrid mismatches or arrangements that are the consequence of a different legal characterization of payments or entities by two legal systems.[113]

The Commission defines hybrid mismatches as:

> [T]he consequence of differences in the legal characterization of payments (financial instruments) or entities when two legal systems interact. Such mismatches may often lead to double deductions [. . .] or a deduction of the income on one side of the border without its inclusion on the other side.[114]

Likewise, the OECD stated in the BEPS Action 2 that:

> [A] deduction/non-inclusion (D/NI) mismatch generally occurs when a payment or part of a payment that is treated as deductible under the laws of one jurisdiction is not included in the ordinary income by any other jurisdiction. Accordingly, a double deduction (DD) mismatch arises to the extent that all or part of the payment that is deductible under the laws of another jurisdiction is set-off against non-dual inclusion income. [115]

From the above, it is possible to conclude that the rule contained in Article 10 of the Proposal for a Directive will apply so long as a different legal characterization to the same entity or instrument exists, and to the extent that characterization origins a mismatch by either a double deduction (DD) or a deduction/non-inclusion (D/NI). The Proposal for a Directive is not sufficiently clear regarding the application of the rule to situations other than DD or D/NI, although an interpretation excluding any situation

[106] Werner Haslehner, *The Commission Proposal for an Anti-BEPS Directive: Some Preliminary Comments*, www.kluwertaxlawblog.com, (accessed 19 Feb. 2016).

[107] Sjoerd C.W. Douma, *Limitations on Interest Deduction: An EU Law Perspective*, 3 British Tax Rev. 364, 371–372 (2015).

[108] Judgment in *SIAT*, C-318/10, EU:C:2012:415, paras 58 et seq.

[109] Judgment in *Itelcar*, C-282/12, EU:C:2013:629, para. 44.

[110] The issue has arisen in multiple scenarios. As per the CJEU jurisprudence on direct tax matters, see Luc De Broe, *International Tax Planning and Prevention of Abuse*, Ch. 2, para. 84 (IBFD 2007). See in the context of the OECDs so-called guiding principle, e.g., Juan Zornoza & Andrés Báez, *The 2003 Revisions to the Commentary to the OECD Model on Tax Treaties and GAARs: A Mistaken Starting Point* in Lang et al. (eds) *Tax Treaties: Building Bridges between Law and Economics*, 153–155 (IBFD, 2010). Within the framework of the Principal Purpose Test rule envisaged in BEPS Action 6, see Michael Lang, *BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties*, 74 Tax Notes Intrl., 655, 659 (2014). See also, Andrés Báez, *supra* n. 84.

[111] All in all, one must admit that the benchmark defined by the Court to consider the existence of an abusive arrangement is lower in the framework of tax-related Directives than in non-harmonized direct taxation cases and hence, should the non-genuine criterion be maintained, there is a great probability that the CJEU would accept it as compliant with EU Law. See Georg Kofler, Mario Tenore, *Fundamental Freedoms and Directives in the Area of Direct Taxation*, in *Traditional and Alternative Routes to European Tax Integration*, Ch. 13 (D. Weber ed., IBFD 2010). See also, Sandra Martinho Fernandes et al., *A Comprehensive Analysis of Proposals to Amend the Interest and Royalties Directive - Part 2*, 51 European Taxation 445, 462 (2011).

[112] Article 10 of the Proposal for a Directive, supra n. 1.

[113] For a very general overview on the rule on Art. 10 see, e.g., Jochen Lüdicke & Florian Oppel, *Der Vorschlag der EU-Kommission einer Anti-BEPS-Richtlinie–ein erster Überblick*, BB, 351 (2016).

[114] See Proposal for a Directive, supra n. 1, at 9.

[115] See OECD (2015), *Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2-2015 Final Report*, OECD-G-20 Base Erosion and Profit Shifting Project, 17 (OECD Publishing, Paris). Although a deep analysis of the concept of 'hybrid mismatch' exceeds the purpose of this article, it is important to highlight that differences in the tax systems around the world, including the different legal characterization of entities and instruments, could be regarded as the simple result of sovereign decisions of the countries, considering their own legal, economic and political aims. Thus, exploiting those differences could be assumed as a natural response to the differences between tax systems. In this position, e.g., H. David Rosenbloom, *Cross-Border Arbitrage: The Good, The Bad and the Ugly*, Taxes–The Tax Magazine, Vol. 85 (2007). See also, H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the 'International Tax System'*, 53 Tax L. Rev. 137 (2000); Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 Geo. L. J. 543 (2001); Mitchell Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 Emory L.J. 89; Michael Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 26 Brook. J. Int'l L.1357 (2001). In contrast, e.g., Reuven Avi-Yonah, *International Tax as International Law: An analysis of the International Tax Regime*, Cambridge University Press, New York (2007). See also, Hugh Ault, *Some Reflections on the OECD and the Sources of International Tax Principles*, 70 Tax Notes Int'l 12 (2013);Yariv Brauner, *An International Tax Regime in Crystallization*, 56 Tax L. Rev. 259 (2003); Luca Dell' Anese, *Tax Arbitrage and the Changing Structure of International Tax Law*, Egea, Milano (2006).

other than DD or D/NI seems to be plausible and also in line with the *Guidance on Hybrid Mismatches Concerning Two Member States* contained in the 2014 Report of the Code of Conduct Group.[116] If a mismatch exists, Article 10 provides that the characterization in the Member State where the payment is sourced must be followed.[117]

2.6.1 *The EU Scenario before the Proposal for a Directive*

The EU scenario before the Proposal for a Directive was basically influenced by the OECD BEPS Action 2, which established the so-called linking rules. Linking rules intend to counteract hybrid mismatches in a two-level manner: (1) a *primary response*, by which the payer country must deny a domestic deduction of an item of income (e.g., interest) if that item of income is not subject to tax in the receiving country, and (2) *defensive rule*, which is applicable in case the primary response was not applied, and which consists in denying an exemption and taxing the item of income received.[118]

Beyond the critics that these measures can have in order to counteract hybrids at the international level,[119] they did not represent a major problem to be rapidly implemented, first at the level of Member States, and then at the EU Law level. For example, at a domestic level, Article 12(1) No. 10 of the Austrian Corporate Income Tax Law included the primary rule stating that interest payments are not deductible at the level of the payor if the payments are made to a foreign corporation of the same group which is not taxed on those payments. [120] A similar rule was contained in Article 15(j) of the Spanish Corporate Income Tax Law, which states that expenses arising from transactions carried out between related parties which, due to the different tax classification do not generate income or generate an exempt income or an income subject to a nominal tax below the 10%, will not be considered as deductible expenses.[121] Likewise, a defensive rule was included in Articles 10(1) and 10(7) of the Austrian Corporate Income Tax Law[122] and Article 21(1)(b) of the Spanish Corporate Income Tax Law.[123] At the EU level, both the primary response and the defensive rule were adopted in the Council Directive 2014/86/EU that modified the Parent-Subsidiary Directive providing that a Member State of a parent company must refrain from taxing profits distributed by qualifying subsidiaries of another Member State only to the extent that the distributions are not tax deductible in the Member State of the subsidiary. If the profit distributions are tax deductible in the Member State of the subsidiary, then the Member State of the parent company will be obliged to tax them.[124] Although the analysis of the compatibility between the linking rules and DTCs and Primary and Secondary EU Law has already been made somewhere else,[125] it should be remarked here that these rules can represent a serious challenge to the fundamental freedoms, which is especially true in the case of the defensive rule. As explained by Rust, mismatches can only be the result of cross-border transactions; therefore, a defensive rule could clearly be regarded as a hidden discrimination.[126] Nevertheless, and practically speaking, the amendment to the Parent-Subsidiary Directive was the only way to create a legal basis for the application of linking rules, because under the former structure of the Parent-Subsidiary Directive it was not allowed that domestic rules deny a dividend exemption in case the payer deducted the same item of income due to a mismatch in the characterization of the income.[127]

Finally, it should be noted that the above-mentioned amendment to the Parent-Subsidiary Directive remained silent on how to deal with payments received from companies located outside the EU, being completely unable to solve mismatches beyond the context of the EU. This issue is repeated under the new Proposal for a Directive that excludes third countries.[128]

2.6.2 *The Immediate Impact of the Proposal for a Directive*

The scenario described above can certainly change if the proposal on hybrids is implemented. In fact, the Proposal for a Directive would turn from the *linking rules* already implemented at a domestic (e.g., in Austria and

[116] The Guidance on Hybrid Entity Mismatches Concerning Two Member States establishes: 'A hybrid entity should be treated as being transparent or not being transparent, in accordance with this guidance and contrary to the treatment that would otherwise apply, only to the extent that it is necessary for the purpose of preventing a double deduction or deduction without inclusion that would otherwise arise, and not for any other purpose.' See Guidance on Hybrid Entity Mismatches Concerning Two Member States, Annex 2, Report of the Code of Conduct Group (Business Taxation), 16553/114 Rev. 1, FISC 225, ECOFIN 1166, Brussels (11 Dec. 2014).

[117] Article 10(1) of the Proposal for a Directive, supra n. 1.

[118] OECD (2015), supra n. 116.

[119] See, e.g. Graeme S. Cooper, *Some Thoughts on the OECD's Recommendations on Hybrid Mismatches*, 69 Bull. Int. Taxn. 6/7 (2015).

[120] See, e.g. s. 12(1) No. 10 of the Austrian Corporate Income Tax Law. See also, Alexander Rust, *BEPS Action 2: 2014 Deliverable–Neutralasing the Effects of Hybrid Mismatch Arrangements and its Compatibility with the Non-discrimination Provisions in the Tax Treaties and the Treaty on the Functioning of the European Union*, 3 British Tax Rev. 308, 311 (2015).

[121] Article 15(j) of the Spanish Corporate Income Tax Law.

[122] See Rust, *supra* n. 121, at 318.

[123] Article 21(1)(b) of the Spanish Corporate Income Tax Law states that dividends whose distribution generates a deductible expense in the payer's jurisdiction, will not be exempted.

[124] See Council Directive 2014/86/EU of 8 Jul. 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L219/40 (2014).

[125] See Rust, supra n. 121. See also, Marjaana Helminen, *EU Law Compatibility of BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements*, 3 British Tax Rev. 325 (2015).

[126] Rust, *Id.* at 320.

[127] Christoph Marchgraber, *Tackling Deduction and Non-Inclusion Schemes–The Proposal of the European Commission*, 54 Eur. Taxn. 4, 142 (2014).

[128] *Infra* section 2.6.2.

Spain) and EU Law level[129] into a simplified system in which a mismatch will be counteracted by following the classification of the instrument or the entity in accordance to the rules set in the country where the payment is sourced. This rule makes certainly more sense in a regional-coordinated context such the EU, and it is also more compatible with some existing domestic legislation in some Member States.[130] For example, the Spanish tax administration, despite the rule provided by the Spanish Tax Law, has a generalized practice to classify foreign entities following the legal characterization made in the other country.[131] This domestic rule coincides with the rule of Article 10 of the Proposal for a Directive in the case where Spain is the country receiving payment.[132]

A similar result in the context of hybrid entities will be achieved by some Member States that apply a so-called *fixed approach* to determine whether a foreign entity is transparent for domestic tax purposes,[133] or those that simply do not contemplate specific rules for characterizing foreign entities, e.g., France.[134] Regarding hybrid instruments, it would be possible that this rule can help solving the classic dichotomy between debt and equity surrounding the whole debate at the domestic level.[135] Accordingly, at the tax treaty level there should not be much concern so long as no similar rule is included in the OECD Model Tax Convention, because the qualification of what is debt and equity for tax treaty purposes will still remain in the concepts of interest and dividend (Articles 10 and 11 of the OECD Model Tax Convention), not affecting domestic tax qualifications.[136] In spite of the above, a positive immediate result can be concluded: there will be no need to force a sovereign Member States to deny a deduction or to tax an item of income to counteract a hybrid mismatch. The above however will require a modification in the current Parent-Subsidiary Directive.

Notwithstanding the positive result that this rule can introduce, Article 10 of the Proposal for a Directive was created to apply only in situations of uncoordinated qualification of an instrument or entity made by two Member States, taking into account again only mismatches into the EU context (excluding third countries). Beyond the practical reasons for that – after all to coordinate twenty-eight countries is easier than to coordinate the whole world –, the exclusion of third countries can have a negative impact upon the competitiveness of some EU Member States' investors. This can easily be seen when comparing US investors with EU investors both willing to invest in Europe. While the formers will not be directly affected by the Proposal for a Directive, which means that they will still enjoy some benefits such as the Check-the-box rules[137]

[129] Supra n. 120.

[130] In an international context, it is more complicated to coordinate in such a way (if not utopic), because it would require a stronger political commitment from all countries and at least the issuance of an instrument different from the bilateral tax treaties, i.e. multilateral agreement that can better represent the will of all countries. The OECD has issued already a proposal to sign a multilateral instrument (BEPS Action Plan 15); however, no draft of that instrument is known up to this date. Additionally, it is questionable whether the OECD is actually the proper place to originate such a proposal, considering the democratic representation problems of this tax forum. For the OECD's proposal of a multilateral instrument see, OECD (2015), *Action 15: A Mandate for Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS*, OECD-G-20 Base Erosion and Profit Shifting Project, (OECD Publishing, Paris). For a critical analysis of the multilateralism and the role of the OECD see, Irma Mosquera, *Legitimacy and the Making of International Tax Law: The Challenges of Multilateralism*, 7 World Tax J. 3 (2015).

[131] Article 37 of the Spanish Non-Resident Income Tax Law (Royal Legislative Decree No. 5/2004 of 5 Mar. 2004) states: 'Those entities incorporated abroad and whose juridical nature is identical or analogous to those of the entities subject to the regime of attribution of income incorporated according to the Spanish Law shall be considered as entities subject to attribution of income (fiscal transparency) regime (unofficial translation)'. The wording of Art. 37 seems to establish a pure resemblance test, however, Spanish tax scholars coincide that when this test is applicable by the tax administration, the tax treatment in the foreign country is the central element to determine the legal characterization of a foreign entity. See, e.g., Domingo Jiménez-Valladolid de L'Hotellerie-Fallois & Félix Vega Borrego, *Chapter 29: Spain* in *Corporate Income Tax Subjects* (ed. D. Gutmann), EATLP International Tax Series, Vol. 12 (2016), 460–464. See also, Alberto Mosquera Mouriño, *Régimen de atribución de rentas: especial referencia a las actividades económicas*, Carta Tributaria 4, 3–16 (2012).

[132] Article 37 of the Spanish Non-Resident Income Tax.

[133] Tax scholars refer to 'fixed approach' in those cases in which all foreign entities are characterized in the same way, i.e., either transparent or opaque. See, e.g., J.F. Avery Jones et. al., *Characterization of Other Sates' Partnerships for Income Tax*, 56 Bulletin for Intrl. Fiscal Documentation 7 (2001). See also, Vijay Kumar, *Conflicts of Qualification and Conflicts of Allocation of Income* in (Eva Burgstaller & Katharina Haslinger eds.), *Conflicts of Qualification in Tax Treaty Law*, 39 (Linde, 2007).

[134] See, e.g., Anne-Sophie Coustel, *France* in in Cahiers de droit fiscal international – Vol. 99B, *Qualification of Taxable Entities and Treaty Protection*, 335 (IFA 2014).

[135] See, e.g. Schön (2012) and Schön (2013), *supra* n. 11.

[136] See F. Alfredo Garcia Prats, *Qualification of Hybrid Financial Instruments in Tax Treaties*, Diritto e Pratica Tributaria Internazionale 984 (2011). See also, Leopoldo Parada, *Is It Debt or Is It Equity? The Problem with Using Hybrid Financial Instruments*, 74 Tax Notes Int'l 4, 352 (2014).

[137] Generally speaking, the US Check-the-box regulations permit to elect the legal characterization of a foreign entity to the extent that this entity is regarded as an 'eligible entity'. This is to say, so long as the entity is not considered as a per se Corporation (opaque) in the United States. For this purposes, the US Internal Revenue Code provides a list of foreign entities regarded as per se Corporation (e.g. *Aktiengesellschaft* in Germany or a *Public Limited Company* in the United Kingdom). For the full list of entities, see I.R.C. s. 301.7701-2(b)(8). Once the election is made, it cannot be changed during the sixty months succeeding the effective date of election. I.R.C. s. 301.7701-3(c)(1)(iv). Finally, it must be remarked that the US tax regulations provide for a default classification of foreign entities. In simple words, unless an election is made, a foreign entity will be considered transparent or opaque considering the concurrence of two characteristics: limited liability and the number of owners that the entity has. I.R.C. s. 301.7701-3(b)(2)(i). For the definition of limited liability, see I.R.C. s. 301.7701-3(b)(2)(ii). For an analysis of the US Check-the-box regulations, see, e.g., Monica Gianni, *International Tax Planning After Check-the-Box*, 2 J. Passthrough Entities 39 (1999). See also, B. Bittker & L. Lokken, *Fundamentals of International Taxation: U.S. Taxation of Foreign*

generating hybrid entity mismatches, the latters will be obliged to counteract such mismatches when two Member States are involved. This can directly benefit the attractiveness of the EU for foreign investors (e.g., US investors), although it can subsequently decrease it for EU investors willing to invest within the EU. The only option to solve that negative effect would be to make applicable the Directive also to mismatches with third countries.[138] However, such an agreement requires not only an amendment in the wording of the Proposal for a Directive, but also a strong political commitment, starting from third countries directly affected, e.g., the United States. Considering the unlikeliness that a country like the United States decides to change e.g., its rules to classify foreign entities for tax purposes, the negative effect described above should be simply assumed as a stranded cost in the implementation of the Proposal for a Directive.

2.6.3 *DD and D/NI Outcomes: Is There a Presumption of Abuse?*

Despite the better approach adopted by the Commission in order to counteract hybrids mismatches, there are still some features in the design of the rules which, regardless the lack of reasonable justifications, seem to be simply assumed as a kind of 'holy grail' in the design of anti-hybrids measures. This is the case of the direct reference to DD or D/NI as the exclusive outcomes triggering the application of the rule. In fact, as per the OECD BEPS Project, the Proposal for a Directive maintains the idea of counteracting exclusively transactions whose outcomes are either DD or D/NI (double non-taxation).[139] Nevertheless, it is evident that other outcomes can come into play when cross-border transactions are involved, not even including hybrids. For example, a non-inclusion/non-inclusion outcomes (generating double non-taxation) could be achieved when the sale of all shares in a non-land-rich company is made by a resident in a State with a participation exemption.[140] Accordingly, it results evident that a deduction is not enough proof of base erosion in the case the payment is subject to withholding tax.[141]

Specifically speaking on hybrid entities, the above carries with it a serious problem, because it implies that the sole outcome of double non-taxation (D/NI) seems to be a presumption strong enough to trigger the re-characterization of an entity, a decision made sovereignly by two Member States. The absence of a satisfactory explanation to focus an anti-hybrid rule on the result of a transaction (DD or D/NI) and not on the purpose of it, distinguishing e.g., between abusive or artificial transactions,[142] distorts the aim of an 'anti-abuse' measure and reinforces the idea that the anti-hybrid mismatches rule at stake creeps closer to a mechanism designed exclusively to generate more revenues rather than to combat abuse. This issue can finally have a negative impact upon many companies in Member States that use legitimate tax planning structures to minimize costs. [143]

3 Conclusions

Unlike the OECD BEPS Project, the Proposal for a Directive is a concrete legislative measure whose consequences can go beyond the EU. In this order of ideas, and based on the analysis of the different proposal contained in the Proposal for a Directive at stake, it is possible to conclude that the establishment of a minimum protection for all Member States' corporate tax systems (which seems to be the ultimate aim of this Proposal for a Directive) is something that should be rather left to the Member States themselves.

Speaking about the concrete measures themselves, it is evident that there is still work to do. First, the interest limitation rule should clarify how it will interact with domestic fiscal unity regimes. As noted in the recent decision on *Zinsschranke* in Germany, there are serious doubts as to whether interest limitation rules comply with a consistent application of the ability to pay principle; thus, further discussion will be needed on this issue. In this regard, the introduction of the ALP as a carve-out clause on the amount of financial expenses equivalent to those of enterprises in similar

Income and Foreign Taxpayers, Thomson Reuters, WG&L, New York, Ed. 2011–2012, at 65–55 and 65–59.

138 Although there would be another option: not to apply any specific anti-hybrid rule.

139 The focus on double deductions and deduction/non-inclusions is not as precise as it appears, because it considers only one year pattern disregarding also the complexity of group taxation. When more than a year is considered, the potential 'double non-taxation' disappears demonstrating that the 'DD' or 'D/NI' outcomes are always more apparent or relatives than real. For a further analysis on this matter see, Jürgen Lüdicke, *'Tax Arbitrage' with Hybrid Entities: Challenges and Responses*, 68 Bull. Intl. Taxn. 6/7 (2014).

140 Cooper, supra n. 120.

141 Although the analysis of this issue exceeds the purpose of this article, it is interesting to raise the question of whether the re-implementation of withholding taxes in the EU would be or not a better way to deal with hybrid issues rather than creating a specific anti-hybrid rule. Of course this issue would be a sensitive matter to discuss within the EU considering its legal framework. *Id.*

142 See *Cadbury Schweppes and Cadbury Schweppes Overseas,* supra n. 68.

143 Tax planning is certainly a legitimate practice whose ultimate goal is to achieve double non-taxation. See Rolf Eicke, *Tax Planning with Holding Companies–Repatriation of U.S. Profits from Europe,* Kluwer Law Intrl., BV The Netherlands, 11–21 (2009). See also OECD, *International Tax Avoidance and Evasion,* 11 (1987). In the United States, e.g., this idea is widely accepted. See *Helvering v. Gregory,* 69 F.2d 809, 810 (2d Cir. 1934). In the same direction, see *Cadbury Schweppes and Cadbury Schweppes Overseas,* supra n. 68. By other side, there is no doubt that the persons called to manage a company are legally bound to involve in tax planning in order to minimize costs. This is explained by Schön as follows: '[T]he minimization of the corporate tax burden [is] an integral part of the managers' duty of care . . .Therefore, they – i.e. the directors themselves – are legally bound to engage in tax strategies.' See Wolfgang Schön, *Tax and Corporate Governance: A legal Approach* in *Tax and Corporate Governance* (ed. Wolfgang Schön), 46 (MPI Studies on Intellectual Property, Competition and Tax Law, Springer, Heidelberg 2008).

circumstances could be considered as an improvement to the current drafting of the rule; however, this is something that will require a further and deeper analysis.

Second, if the Commission insists on an exit tax provision, it would be desirable to approximate the tax treatment of EU/EEA and third-state transactions and at least to accomplish with the jurisprudence of the CJEU.

Third, and regarding he CFC rule, there is no satisfactory explanation on why the comparison of tax rates must be made by reference to effective tax rates between the country of residence and the country of the controlling entity and not to statutory ones, as it is established in Article 6 (switch-over clause). In addition, there is no justification to set up a 'non-genuine' criterion regarding CFC rules, mostly when it contradicts the wholly artificial arrangement criterion explicitly posed by the CJEU on these matters.

Fourth, and although the proposal on hybrids appears in principle to be more effective than other international measures proposed in the past, i.e., 'linking rules', there still exist serious doubts on why the application of an anti-hybrid rule should be linked exclusively to the outcomes of DD or D/NI. This issue does not only exclude some other artificial transactions that can generate a similar effect (e.g., non-inclusion/non-inclusion), but also it constitutes a real presumption of abuse that can finally affect some legitimate transactions. A further analysis on this issue exceeds the purpose of this work; however, the question should at least be raised.

Finally, some measures contained in the Proposal for a Directive should be seriously reconsidered, if not directly excluded based on their immediate negative effects on the internal market. This is the case of the switch-over clause and the inclusion of a common GAAR.

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