UNITED IN DIVERSITY, DIVIDED BY SOVEREIGNTY: HYBRID FINANCING, THIN CAPITALIZATION, AND TAX COORDINATION IN THE EUROPEAN UNION

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I. INTRODUCTION

"United in diversity!"[1] The motto of the European Union (E.U.) signifies how Europeans have come together to work for peace and prosperity, while at the same time being enriched by Europe's many different cultures, traditions, and languages. However, in the face of increasing global financial innovation, the E.U.'s inability to come together and implement a system of tax coordination has hindered its prosperity and economic well-being. The diversity of Member States'[2] tax systems, when merged with the European Court of Justice's application of the E.U.'s four freedoms, has often led to detrimental consequences for the taxing powers of the Member States and its taxpayers. To prevent further harm, Member States have steadfastly fought to maintain their sovereignty with respect to tax issues.

Overcoming Member State reluctance to conform will not be an easy task. National self-interest and distrust has deep historical roots. Additionally, democratically bringing together Europe's different political, social, economic, and legal cultures presents challenges unlike any seen in modern times. Without a proven roadmap, the E.U. has had to cautiously proceed by trial and error; understanding that one serious misstep or series of missteps could have lasting, devastating effects. Nevertheless, as long as Member States' sovereign and

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[1] *The EU Motto*, EUR. UNION, http://europa.eu/about-eu/basic-information/symbols/motto/index_en.htm (last visited Sept. 7, 214).

[2] Member States are the 28 European countries that make up the E.U.. *EU Member Countries*, EUR. UNION, http://europa.eu/about-eu/countries/member-countries/index_en.htm (last visited Sept. 7, 2014).

national interests dominate, E.U. tax coordination will not occur, causing it to fall further behind global economic competition.

Global economic integration in the world of international finance has taken a remarkably fast path since the late 1990s. Offshore investments are now considered a question of business survival in an increasingly international and competitive arena. This has been particularly true in the field of cross-border capital flows. Investors have "expanded several new forms of vehicle and business instrument (previously used only domestically), in order to find different ways to enter these emerging markets and create new forms of investors (e.g. capital investors from risk taker investors)."[3] Yet, it is claimed that heavy reliance on innovative financial instruments might not only result in extraordinary disorder, financial panics, and banking crises, but also that "the process of financial globalization propelled by the information revolution and technological innovations has posed potential dangers to countries' abilit[ies] to pursue national tax regimes thereby generating revenue losses and fiscal threats caused by taxpayers' shifts in financial activities by seeking cross-border tax arbitrage and lower tax jurisdictions."[4]

Within the European Union, hybrid financial instruments[5] took off when the euro was introduced. However, the real shift towards a massive use of hybrid instruments issued by companies outside the financial sector really started in 2005. Tax planning in the area of financial instruments has primarily focused on the analysis of the tax treaties' network signed by the target country which will receive the foreign investments. Nonetheless, in the context of intra-E.U. transactions, the analysis of E.U. Law and, in particular, of E.U. secondary law is of significant importance.

The taxation of cross-border hybrid financial instruments poses a number of questions among which the most significant one is certainly how the characterization of income affects taxation within the E.U. Specifically, can, and if so, should the E.U. control those Member States that tax capital gains at more favorable rates when compared to ordinary income? As financial instruments grow more complex, the issue of characterizing the income generated by them increases, as does the problem of withholding tax from income derived from these hybrid financial instruments. For instance, some Member States may impose withholding tax on dividends, but not on interest or capital gains. In other words, discrepancies among countries in terms of legislative definitions of payments subject to withholding tax are likely to cause difficulties because the payments

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[3] Leonardo Freitas de Moraes e Castro, *Treatment of Hybrid Entities and Financial Instruments in the OECD Model Convention: Impact on the Structure of Foreign Investments*, 10 BUS. L. INT'L 280, 281 (2009).

[4] Insop Pak, *International Finance and State Sovereignty: Global Governance in the International Tax Regime*, 10 ANN. SURV. INT'L & COMP. L. 165 (2004).

[5] Hybrid financial instruments generally possess equity and debt characteristics falling under more than one single tax classification or may not be assigned to any classification at all.

made under hybrid financial instruments can take forms that are different from payments traditionally subject to withholding taxes.[6]

To illustrate the necessity of a better taxonomy for hybrid instruments, one may consider the case of a hybrid instrument treated as debt in the jurisdiction of the issuer and as equity in the jurisdiction of the investor. The issue thereafter is whether to adopt the characterization by the issuer's Member State that chooses the legal approach (debt) or that of investor's country which applies an economic substance approach, thus treating the payment made out of the financial instrument as equity. Characterization of such instruments under the debt/equity distinction is of particular interest for both the issuer and the investor. If treated as interest, it will likely be tax-deductible to the issuer. On the other hand, the classification will determine whether the income received is treated as a dividend or as interest to the investor.[7]

Because financial instruments largely differ in their characteristics, it is often argued that the distinction between debt and equity is one of degree rather than one of principle.[8] Indeed, although pure debt instruments have a fixed maturity and a fixed return, pure equity instruments have no maturity and a return attached to firm profits; such characteristics can be combined so as to "obtain two hybrid instruments: a perpetual loan, which has a fixed return and no maturity, and a profit sharing loan, which has fixed maturity and a return that is linked to firm profits."[9]

The dichotomy between domestic laws is often referred to as the debt-equity continuum, and has led the doctrine to emphasize the importance of general anti-abuse rules in combatting tax planning in relation to cross-border hybrid instruments. Because tax planning in this field represents an effective and relatively low-risk task, policymakers have shown an awakening interest for anti-abuse enforcement. The Internal Revenue Service,[10] for example, announced in 2007 that cross-border hybrid instruments were one of its highest compliance priorities, giving the perception that tax planning in this area is considered to potentially have a substantial adverse effect on collected corporate tax revenues.

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[6] *See* Ad Hoc Grp. of Experts on Int'l Cooperation in Tax, *International Tax Aspects of New Financial Instruments*, U.N. Doc. ST/SG/AC.8/2001/L.6 (2001).

[7] *See, e.g.*, Eva Eberhartinger & Martin Six, *National Tax Policy, the Directives and Hybrid Finance: Options for Tax Policy in the Context of the Treatment of Hybrid Financial Instruments in the Parent-Subsidiary Directive and the Interest and Royalties Directive* (SFB Int'l Tax Coordination, Discussion Paper No. 16, 2006).

[8] Adam O. Emmerich, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. CHI. L. REV. 118, 122 (1985).

[9] Niels Johannesen, *Strategic Line Drawing between Debt and Equity* 2 (Oxford Univ. Cent. for Bus. Taxation, Working Paper No. 12/03, 2011).

[10] Doug Shulman, Commissioner, Internal Revenue Service, Remarks before the Organisation for Economic Co-operation and Development (June 2, 2009), *available at* http://www.irs.gov/uac/Commissioner-Doug-Shulman%27s-Remarks-to-the-OECD,-June-2,-2009.

The sovereign right of tax legislation is preserved for each E.U. Member State to the extent it complies with E.U. law in respecting the four freedoms contained in the E.U. Treaties along with secondary E.U. law[11] and the code of conduct for business taxation.[12] In the area of direct taxation, only a few directives have been introduced. Although the choice of directives over regulations has been made, the detailed nature of the directives has been shown to actually restrain the Member States' autonomy with respect to their implementation.

In the area of hybrid finance, the Parent Subsidiary Directive and the Interest and Royalties Directive are not only relevant, but they have been shown to cause unresolved issues in the characterization of certain hybrid instruments and their yield, especially where thin capitalization legislation applies. Because the characterization of the instrument invokes the application of one particular directive rather than the other, the amount of income taxes a Member State may levy is directly affected.

In order to understand the challenges facing the E.U. in the coordination of tax issues and hybrid financial instruments, this article first discusses the history of how the E.U. was formed. It demonstrates Europe's post-World War II struggles and the existence of national self-interest and mistrust that remain obstacles today. Part II compares the challenges facing the E.U. with those faced by the United States in trying to put together different governments and reconcile different rules. Part III explains why it is hard for the E.U. to come up with one set of rules or, in other words, what the Member States are trying to protect and their reluctance to hand over taxation authority to the E.U. Part IV of this article attempts to analyze the particular context of hybrid finance and thin capitalization within the European Union. Part V addresses the questions raised by the application of the Interest and Royalties Directive and the Parent Subsidiary Directive with respect to hybrid financial instruments, with particular emphasis on the thin capitalization-related issues. Finally, Part VI briefly discusses the possibility of E.U. institutions adopting a common thin capitalization clause in the context of the Common Consolidated Corporate Tax Base (CCCTB).

II. HISTORY OF THE ECONOMIC UNION

After World War II, Europe dramatically changed. Germany was thoroughly defeated and occupied by Britain, France, the Soviet Union, and the United States. Soviet-controlled communist parties came to power throughout Eastern Europe seizing private property, establishing command economies, and

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[11] *See* PAUL CRAIG & GRAINNE DE BURCA, EU LAW: TEXT, CASES, AND MATERIALS 112 (5th ed 2011).

[12] Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a Code of Conduct for Business Taxation, 1998 O.J. (C 2) 2.

imposing dictatorial governments. Aware of the developing threat to the east, and attempting to recover from the consequences of war, Western Europe was in considerable need of economic recovery, political stability, and military security. Emerging from the war more powerful than any other liberator, the United States played a major role in helping to achieve all three.

A. The Marshall Plan

The United States believed that European economic integration would not only establish a new, open, international economic system, but also protect Western Europe from internal communist subversion and contain the Soviet Union from gaining ground within Western Europe. To enhance regional security and accelerate economic recovery, the United States established an international economic system favorable to free trade, and promoted economic interdependence and integration.

Popular support for European integration in the immediate postwar years was widespread. Germany was eager to rehabilitate the country's reputation with its neighbors, and welcomed the possibility of integration.[13] As stated in Winston Churchill's speech in Zurich,[14] the original hope was that the Soviet Union would play a major role in European integration. However, the reality of the emerging Cold War meant that this initiative would be restricted to Western Europe and, therefore, to West Germany.[15]

Western Europe acknowledged the need to bring Germany back into the international fold. However, concern arose over how to realize West Germany's huge economic potential without risking a return to German hegemony. The United States wanted an economically strong Germany, particularly in the context of the worsening Cold War, and encouraged any promising moves toward integration that might further a "United States of Europe." The first step towards economic recovery was the Marshall Plan.

At Harvard University, on June 5, 1947, U.S. Secretary of State George Marshall spoke on an initiative of financial aid for Europe. He called for a plan

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[13] ALAN S. MILWARD, THE RECONSTRUCTION OF WESTERN EUROPE 1945-51 250 (1984) [hereinafter MILWARD, THE RECONSTRUCTION OF WESTERN EUROPE].

[14] On September 19, 1946, Winston Churchill gave an inspiring speech at the University of Zürich for integration in Europe. It called for "a sort of United States of Europe. . . . France and Germany must take the lead. Great Britain, the British Commonwealth of nations, mighty America - and I trust Soviet Russia . . . must be the friends and sponsors of the new Europe." Winston Churchill, Address at the University of Zurich (Sept. 19, 1946), *available at* http://www.coe.int/t/dgal/dit/ilcd/archives/selection/churchill/ZurichSpeech_en.asp.

[15] The Cold War between the United States and U.S.S.R. began with the announcement of the Truman doctrine to Congress on March 12, 1947. This led to 40 years of great distrust between the superpowers.

that "should be a joint one, agreed to by a number, if not all, European nations."[16] This plan would become known as the Marshall Plan. Under the Marshall Plan, the United States and Western Europe worked together to adopt U.S. business practices and to create a European marketplace similar to that of the United States: large, integrated, and efficient. By several accounts, it had a profound effect on European integration. The Marshall Plan's creative mechanisms transferred the best of U.S. commercial organizations, social patterns, and technology, and attempted to create an open, unified international market.[17]

B. The Treaty of Paris and the ECSC

Economic integration continued to develop as a solution to revive postwar Europe. The Treaty of Paris was signed on March 19, 1951, by France, West Germany, Belgium, Italy, Luxembourg, and the Netherlands.[18] It established the European Coal and Steel Community (ECSC), thus creating a regulated common market arrangement for coal, steel, coke, iron ore, and scrap. In recognition of coal and steel's importance to economic and military power, the Treaty of Paris created the first integrated organization offering the prospects of permanent integration. Coal and steel had provided the military capacity for invasions and a motive for territorial acquisitions. By incorporating these economic sectors into an integrated organization with a common management system, no country on its own would be able to make weapons to turn against another.[19]

ECSC represented a revolution in French and West German relations. Nearly a century of wars, attempted domination, and antagonism (that some had called hereditary), had given way to cooperation.[20] For France, accepting the ECSC meant abandoning decades of protectionism, overcoming deep distrust of Germany, and embracing economic modernization. For Germany, it offered salvation and international rehabilitation.

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[16] *The "Marshall Plan" speech at Harvard University, 5 June 1947*, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, http://www.oecd.org/general/themarshallplanspeechatharvarduniversity5june1947.htm (last visited Nov. 12, 2014).

[17] JOHN KILLICK, THE UNITED STATES AND EUROPEAN RECONSTRUCTION, 1945-1960 185 (1997).

[18] In August 1952, after ratification by the six parliaments, the ECSC started to function and in 1953 the Common Market commenced operations.

[19] According to Alan Milward, the founding fathers "recognized or stumbled upon the need for those limited surrenders of national sovereignty through which the nation-State and western Europe were jointly strengthened, not as separate and opposed entities, but within a process of mutual reinforcement." ALAN MILWARD, THE EUROPEAN RESCUE OF THE NATION STATE 319 (2000) [hereinafter MILWARD, THE EUROPEAN RESCUE OF THE NATION STATE].

[20] ROBERT MARJOLIN, ARCHITECT OF EUROPEAN UNITY: MEMOIRS 1911-1986 273 (1986).

The ECSC achieved its long-term objective of creating a way for West Germany to safely reemerge.[21] It allowed Western Europe and West Germany to coexist and conduct business in the absence of any treaty or formal peace settlement by creating a formalized network of economic interdependence;[22] an alliance that has endured and laid the basis for peace, prosperity, and reconstruction in Western Europe.

C. The Treaty of Rome and the Four Freedoms

On March 25, 1957, the six ECSC countries[23] signed the Treaty of Rome,[24] renaming their union the European Economic Community (EEC). The Treaty of Rome sought to deepen economic integration at a time of increasing intra-European trade.[25] Beginning operations in January 1958, the EEC was designed to implement a program for economic and commercial expansion in Western Europe by removing tariffs and quantity restrictions to create a single common market.[26] The objective behind creating a common market was to produce one large integrated economy; merging the six national economic systems into one domestic economy with common policies, common rules, and the

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[21] According to Schuman, this was initial step on the road to a wider objective:

> In this way, there will be realized . . . that fusion of interest which is indispensable to the establishment of a common economic system; it may be the leaven from which may grow a wider and deeper community between countries long opposed to one another by sanguinary divisions. . . .
>
> This proposal will lead to the realization of the first concrete foundation of a European federation indispensable to the preservation of peace.

The Schuman Declaration – 9 May 1950, EUROPA.EU, http://europa.eu/about-eu/basic-information/symbols/europe-day/schuman-declaration/index_en.htm (last visited Nov. 12, 2014).

[22] MILWARD, THE RECONSTRUCTION OF WESTERN EUROPE, *supra* note 13, at 418.

[23] The six signatory countries were France, West Germany, Belgium, Italy, Luxembourg, and the Netherlands.

[24] The Treaty of Rome is also known as the Treaty on the Functioning of the European Union or TFEU.

[25] When Saar, a region of Germany controlled by France since World War II, was handed back to West Germany on January 1, 1957, political tension eased further between France and West Germany, facilitating progress in trade and the TFEU.

[26] ERNST HAAS, THE UNITING OF EUROPE: POLITICAL, SOCIAL, AND ECONOMIC FORCES 102-10 (1958). On the deconcentration issue, see JOHN GILLINGHAM, COAL, STEEL, AND THE REBIRTH OF EUROPE, 1945-1955 255-62, 266-81(2005); A. W. Lovett, *The United States in the Schuman plan: A study in French Diplomacy, 1950-1952*, 39 HIST. J. 425-55 (1996).

fundamental founding principles of the free movement of goods, persons, services, and capital, which came to be known as the Four Freedoms.[27]

The principle of free movement of goods implies that national barriers to the movement of goods within the E.U. disappear.[28] This principle prohibits quantitative restrictions on imports, exports, or goods in transit, and all measures having equivalent effect between Member States. The freedom of movement for persons guarantees every E.U. citizen the right to move freely, to stay, and to work in another Member State.[29] It means that discrimination on the basis of nationality, residence, and/or language is not permissible; it also includes equal treatment in basic employment conditions, remuneration, dismissal, and the receipt of social advantages. The freedom to provide cross border services and the freedom of establishment provides individuals and companies the right to take on and pursue activities in another Member State without discrimination. The principle of freedom to provide services enables an economic operator providing services in one Member State to offer services on a temporary basis in another Member State, without having to be established. Incorporated within the freedom of services, the principle of freedom of establishment enables an economic operator (whether a person or a company) to carry on an economic activity in a stable and continuous way in one or more Member States.[30] The free movement of capital enables integrated, open, competitive, and efficient financial resources within the E.U.; facilitates trade across borders, favors workers' mobility; and makes it easier for businesses to raise the money they need to start and grow. For citizens, it means the ability to perform many operations abroad as diverse as opening bank accounts, buying shares in non-domestic companies, investing where the best rate of return may be realized, and purchasing real estate. For companies, it means being able to invest in, own, and take an active part in the management of other European companies.

The United States' support for the EEC was two-fold. First, it believed that a common market had the potential for greater trade, not only among EEC Member States, but also between them and the United States. Second, because political stability, particularly democratic stability, depended on economic success, further European integration would provide a framework to anchor West

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[27] With the signing of the Single European Act in 1986, there was push to make the Four Freedoms fully operational. Currently, however, the Freedoms do not fully exist in practice. For example, bureaucratic hurdles still exist when trying to settle in another E.U. Member State or attempting to do business in one country while based in another.

[28] Many barriers have been lifted through harmonization in the E.U. such as in the field of vehicles, pharmaceuticals, medical devices, chemicals, construction products, gas appliances, electrical equipment, mechanical equipment, metrology, pressure equipment, cosmetics, footwear, textiles, toys, and others.

[29] Exceptions can only be made in the public sector.

[30] This principle also applies to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of another Member State.

Germany in Western Europe, strengthen Western Europe's ability to withstand communism, and stand with the United States as a strong transatlantic ally.[31]

D. Eurosclerosis & Increasing Global Competition

Because there were few new initiatives and no further successful integration from the mid-1960s to the early 1980s, the EEC was described as suffering from "Eurosclerosis."[32] However, some significant changes did occur during this period. In 1968**,** the EEC eliminated all quotas and tariffs (duties on imported goods) from the trade in goods within its borders. It also replaced national customs duties on trade with the rest of the world with the Common Customs Tariff.[33]

In January 1973, Britain, Denmark, and Ireland joined the EEC. Unfortunately, this coincided with international financial instability and the oil crisis of the early 1970s. Among other things, enlargement of the EEC from six to nine countries made agreement more difficult given the need for unanimity following the Luxembourg Compromise.[34] The enlarged EEC continued on as it struggled through a decade of brutal economic conditions: sluggish growth, rampant inflation, and rising unemployment.

Unable to reach unanimity on major issues, the EEC experienced a virtual discontinuation of progress toward a single market during the late 1970s and early 1980s. With Europe's increasingly uncompetitive national economies being too rigid and fragmented, economists, government officials, and politicians recognized that to compete with Japan, the United States, and the newly industrialized countries of the Pacific Rim (South Korea, Taiwan, Hong Kong, and Singapore), European companies needed to become globally competitive and treat the EEC as their home base. Fortunately, in the mid-1980s the EEC sprang

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[31] U.S. DEP'T OF STATE, 7 FOREIGN RELATIONS OF THE UNITED STATES, 1958-1960: *Western European Integration and Security; Canada* 121 (1993), *available at* https://history.state.gov/historicaldocuments/frus1958-60v07p1/pg_121.

[32] John Pinder, *History, Politics and the Institutions of the EC*, *in* BRITAIN WITHIN THE EUROPEAN COMMUNITY: THE WAY FORWARD 30 (Ali M. El-Agraa ed., 1983).

[33] Unfortunately, non-tariff barriers, such as differences between the Member States' safety and packaging requirements or between national administrative procedures, continue to remain. These barriers prevent manufacturers from marketing the same goods all over Europe.

[34] *See* Marjolin, *supra* note 20 (arguing that the agreement was an impediment in important spheres of policy for the next fifteen to twenty years). The Luxembourg Compromise occurred in January 1966, when the original six union countries agreed to the French demand—in deviation to the Treaty of Rome—that decisions made by EEC Council of Ministers (the decision-making body of the EEC) would not be passed by a qualified majority of votes, but by unanimity. This created the possibility of a national veto which greatly hindered decision-making.

back to life, overcoming the problems of "Eurosclerosis," and began to confront the challenges of global economic competition.

E. The Single Market and the EC

In 1985, a comprehensive blueprint was published, connecting the fragmented national markets to create a frontier-free single market by the end of 1992. From this blueprint the first major treaty reform in the EEC's history, the Single European Act (SEA), was developed in 1986. To usher in this new era, the EEC became the European Community (EC). In order to accelerate implementation of the single market program and facilitate much-needed decision-making, the SEA abolished the requirement of unanimity installed by the Luxembourg Compromise and extended qualified majority voting (QMV) for all internal market legislation.[35] This action was vital to the harmonization of regulations before the 1992 deadline.

Although customs duties disappeared in 1968, trade was not flowing freely across EC borders; the main obstacle being differences in national regulations. To improve the benefits of one large European market, the EC adopted legislation to open previously closed national markets. In many areas, national regulations were replaced by one common European rule, which vastly reduced the complications and costs for any business trying to market a product throughout the EC. In other areas, to avoid having to adopt new legislation, the Member States simply agreed to give each other's laws and technical standards the same validity as their own (the "mutual recognition" principle).[36]

The fast growth of the late 1980s abruptly dissipated and once again the EC fell on hard times. In the early 1990s, inflated claims of single market success and a severe economic downturn soured the public and political attitudes toward European integration. The collapse of communism in central and Eastern Europe, the imminent German unification, and the end of the Cold War had a profound impact on public perceptions of the course of European integration and the EC.

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[35] On the single market program, see BILL LUCARELLI, THE ORIGIN AND EVOLUTION OF THE SINGLE MARKET IN EUROPE (1999); ROLAND BIEBER ET AL., 1992: ONE EUROPEAN MARKET (1988); MICHELLE EGAN, CONSTRUCTING THE EUROPEAN MARKET: STANDARDS, REGULATION, AND GOVERNANCE 109-32 (2001); JACQUES PELKMANS & ALAN WINTERS, EUROPE'S DOMESTIC MARKET (1988); MICHAEL CALINGAERT, THE 1992 CHALLENGE FROM EUROPE: DEVELOPMENT OF THE EUROPEAN COMMUNITY'S INTERNAL MARKET (1988).

[36] *See* Frans Vanistendael, *Cohesion: The Phoenix Rises from His Ashes* 14 EC TAX REV. 208, 217 (2005).

F. The E.U. Emerges

To evolve with the changing environment, the Treaty on European Union (TEU) was created in December 1991. The TEU was more than the final name change from the EC (1986) to the European Union. Considered as one of the greatest milestones in the history of European integration, it produced an organization of European states with strong federal attributes by transforming and pooling national sovereignty in several policy areas,[37] incorporating the objective of a single currency, and extending the E.U.'s legal scope. Additionally, the single market and its Four Freedoms[38] became a reality.[39]

In October 2002, the Treaty of Nice was accepted and came into effect in February 2003. The Treaty of Nice made alterations to the rulebook and voting procedures to allow the E.U. to grow from fifteen states, to as many as thirty. It extended qualified majority voting to cover 90% of E.U. law. As a result, QMV ended national vetoes in twenty-three separate E.U. articles. Unanimity remains only with regard to a small core of articles: taxation, social security, and immigration. Due to these changes, the enlarged E.U. operates more efficiently than before.

The Treaty of Lisbon was ratified on December 1, 2009. Its goal was to make the E.U. more democratic, efficient, transparent, and better able to tackle global challenges. The Lisbon Treaty sought to do this by clarifying which powers belong to the E.U., which belong to E.U. Member States as sovereign powers, and which were to be shared by the E.U. and its Member States. Today, the European Union's twenty-eight Member States and single market population of over 503 million people operate under the Lisbon Treaty's rules and the QMV system. The E.U. represents 8% of the world's population and 40% of the world's trade in goods (double the share of the United States).

III. MERGING GOVERNMENTS AND RECONCILING RULES: COMPARING THE E.U. AND U.S. EXPERIENCES

The institutional structure that developed from E.U. integration is similar to that of the United States. The United States and the E.U. both emerged from

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[37] These areas included consumer protection, free movement of labor, and rights of professionals throughout the E.U., training young workers, environmental protection, and the Social Chapter on Workers' Rights.

[38] The Four Freedoms (the free movement of goods, services, people, and capital) were established by the Treaty of Rome (1957).

[39] The abolition of trade barriers led Chancellor Helmut Kohl to say on October 12, 1991, "the most important thing is that it is clear that what we are doing is irrevocable, on the way to political union we are now crossing the Rubicon. There is no going back." MARTIN J DEDMAN, THE ORIGINS AND DEVELOPMENT OF THE EUROPEAN UNION 1945 - 2008: A HISTORY OF EUROPEAN INTEGRATION 133-34 (2d ed. 2010).

the combination of distinct Member States; both manage vast territories with large populations; both have liberal democracies; and both possess highly complex economies. However, the E.U. contains political, social, cultural, economic, and legal dissimilarities which create different challenges.

A. Political Challenges

European integration began after 1945, when national reconstruction and economic recovery plans depended on West Germany's economic restoration in the European economic system.[40] European integration occurred because it was a way to a secure, permanent, law-abiding arrangement within Western Europe. An integrated organization,[41] rather than interdependent organization,[42] was created because of three key advantages.[43] First, the agreements struck between Member States are irreversible (or at least less easily reversed). This provides more assurance that, once made, arrangements and policies will be adhered to continuously. Second, it allows for exclusiveness whereby the "*acquis communitaire*"[44] concept makes the integrated organization a strong cohesive

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[40] MILWARD, THE EUROPEAN RESCUE OF THE NATION STATE, *supra* note 19, at 155-67; MILWARD, THE RECONSTRUCTION OF WESTERN EUROPE, *supra* note 13, at 492-502.

[41] *See* ALAN S. MILWARD ET AL., THE FRONTIER OF NATIONAL SOVEREIGNTY: HISTORY AND THEORY 1945-1992 24 (1993). An integrated organization requires the creation of a "supranational organization" such as the ECSC and the EEC. *Id.* Here, the Member States transfer some policy decisions to a body of all Member States, the decision of which are binding on all members and have to be followed. So Member States within supranational organizations transfer some power (sovereignty) to that organization. Furthermore, the supranational organization has the power to impose sanctions on member governments, in cases of noncompliance with policy decisions or breaches of agreements. For example, in the E.U. one of the functions of the European Commission is to act as a "policeman" to ensure compliance and another E.U. body, the European Court of Justice, makes legal judgments that take precedence over Member States' national law in cases of dispute.

[42] *Id.* International organizations, such as the Organization for Economic Cooperation and Development (OECD), the General Agreement on Tariffs and Trade (GATT) and the North Atlantic Treaty Organization (NATO) operate on the basis of "interdependence," i.e. a group of national governments cooperate together in certain policy areas and agreements are made based on mutual operation. Such organizations do not interfere with the policymaking of the Member States, their decisions do not overrule national policies and there is little if any power or sanction to impose policies on Member States. This is the most common type of international organization or basis of agreement.

[43] *Id.* at 26 (identifying three key advantages of European economic integration).

[44] *See* TIMOTHY BAINBRIDGE & ANTHONY TEASDALE, THE PENGUIN COMPANION TO EUROPEAN UNION 4 (1995). The phrase *acquis communitaire*, sometimes translated as "the Community patrimony," denotes the whole range of principles, policies, laws, practices, obligations, and objectives that have been agreed or that have been developed within the

force, enhances its bargaining position, and provides the potential to discriminate against outsiders. Third, an integrated organization creates new legal systems and frameworks to regulate the institutions and members' powers, rights and obligations; thus making it more law-abiding than an interdependent organization.

The E.U.'s system is more complex than the federal system of the United States.[45] The U.S. federal system is constitutionally organized around two levels of government: the federal center and the federated units or states. The E.U. was not set up as a step towards inclusion of the Member State within a federal Europe.[46] The E.U. was structured around local, regional, national, and international levels of government. The various combinations among these components have introduced additional levels of decision-making. Actual political and decision-making power remains with Member States acting together within the E.U.; all decisions are made by the Member States' governments collectively in the E.U. Council of Ministers. Moreover, the E.U. lacks the ability to enforce the laws it makes. With its very small permanent bureaucracy and limited budget, it has to rely upon the public administrations of Member States to implement the laws made at the European Union level. As a result, the E.U. is a system without a centralized form of governance, where power is diffused and authorities overlap.

Although the E.U. represents a triumph of voluntarily shared sovereignty over political division and excessive nationalistic ambition, operationally it continues to be an unclear and complex system of governance. As was the case for its precursor, the ECSC, the E.U.'s Member States continue to be motivated by the common trait that persists throughout the history of European integration: the predominance of national interests.[47] The difference now is that national interests are often undisguised and harder to reconcile.

One of the E.U.'s most challenging tasks, the process of enlargement, has required a balancing act to maintain the political, geographic, demographic, and economic symmetry of the E.U., bringing with it the need to absorb new languages and national perspectives. E.U. membership has grown from twelve states in 1992, to twenty-eight by 2013, leading to large regional differences within the union.[48] In Northern Europe, production is capital-intensive, using

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European Union. The *acquis communitaire* includes most notably the Treaties in their entirety, all legislation enacted to date, and the judgments of the Court of Justice.

[45] *See* DEMOCRACY AND FEDERALISM IN THE EUROPEAN UNION AND THE UNITED STATES 8 (Sergio Fabbrini ed., 2005) [hereinafter DEMOCRACY AND FEDERALISM IN THE E.U. AND THE U.S.].

[46] MILWARD, THE EUROPEAN RESCUE OF THE NATION STATE, *supra* note 19, at 11-13 (arguing that European integration did not advance the cause of Federation, but actually rescued the Member State because of economic necessity and political security).

[47] DESMOND DINAN, EUROPE RECAST: A HISTORY OF EUROPEAN UNION 321 (2004).

[48] In 1995, there was the Alpine Arctic enlargement consisting of Austria, Sweden, and Finland. In 2004, ten states from the Baltic through Central and Eastern Europe to the Mediterranean joined (Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia,

skilled labor; in Southern Europe, production is more labor intensive, using low-skilled labor. Germany, Holland, Denmark, and the United Kingdom instinctively favor free trade in open markets; Spain and France mistrust market forces they cannot influence. To date, real signs of convergence between North and South have not occurred as predicted.

B. Social & Cultural Challenges

Enlargement has also created an E.U. population that is divided into a few large states and many small states. The small states view their large state counterparts as predisposed to being overbearing, arrogant, and willing to run roughshod over their views. The citizens of small states feel threatened by the large states' political and economic power. Although the E.U. has given small states a greater share of power than any other international organization, the small states are constantly worried that their relative share of power will be eroded.[49] As such, some small states and "Eurosceptic" states, like Poland and the Czech Republic, have become more vocally opposed to further integration.

Additionally, rapid enlargement has fueled public fears about legitimacy and democratic control. By eliminating trade barriers and facilitating movement across borders, European integration has benefited the people of Europe directly, but often imperceptibly.[50] The E.U.'s institutions are accountable to its citizenry: people vote directly for national government, which appoints the Council of Ministers and the European Council (of national leaders), and vote directly for the European Parliament, which has considerable budgetary and decision-making power as well as oversight authority. However, there is little popular support for movement towards a European federal government among Member States' citizens.[51] E.U. citizens complained about the E.U.'s remoteness, the comprehensibility of decision-making, rampant wastage and frauds,[52] and the

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Hungary, Slovenia, Malta, and Cyprus). Bulgaria and Romania joined in 2007 and Croatia joined in 2013.

[49] *See* DEMOCRACY AND FEDERALISM IN THE E.U. AND THE U.S., *supra* note 45, at 171.

[50] DINAN, *supra* note 47, at 7 (2004).

[51] Germany is generally interested in a European federal government. However, unitary states like Britain and France see federalism as a threat to their national identity and sovereignty. Further, E.U. members from Central and Eastern Europe are not eager about being in a federal superstate, having recently escaped the Soviet Empire and attained full sovereignty.

[52] *See, e.g.*, MICHAEL SHACKLETON, FINANCING THE EUROPEAN COMMUNITY 38 (1990). Accountability has always been very weak. In 1987, the E.U. Court of Auditors investigated four Member States (Britain, France, Germany, and Ireland) regarding the export refunds paid in the beef meat sector. It found that claims for refunds were granted even though product was not exported at all, the product exported was not beef, or the product was not exported to the intended destination. *See also* DINAN, *supra* note 47, at

unaccountability of the unelected, but seemingly all-powerful, European Council of Ministers.

The sentimental power of nationality endures in Europe. Few E.U. citizens see themselves as European first and foremost. The moral and ethical legitimacy for nationalism is especially strong where national boundaries coincide, satisfying people's need for cultural roots and security, as well as creating their political community.[53] They perceive further transfers of sovereignty and lawmaking to the E.U.'s supranational Council of Ministers and other such institutions as reducing national sovereignty and diminishing national identity. Many E.U. citizens think that, unlike national parliaments, European Parliament is not a real legislature and, thus, lacks adequate legitimacy. This has led to a failure of E.U. citizens to turn out for European Parliament elections[54] or to hold national politicians responsible for their votes in the Council of Ministers.

C. Economic & Legal Challenges

The experiences of public authority and market building in the United States and the E.U. have been quite different. The inconsistency relates to the different types of public authority wielded by the state.[55] In the countries of Western Europe, the Member States preceded the formation of the economic market, and thus defined social relations among the Member States. In the United States, the economic market preceded the formation of the federal state, and thus

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164-65. According to estimates provided by Court of Auditors in 1993, 10% of the budget was wasted each year. Also, in 2004, Court of Auditors' Chief Accountant Marta Andreasen was fired as a whistleblower after stating the E.U.'s budget was an "open till waiting to be robbed." JOHN GILLINGHAM, DESIGN FOR A NEW EUROPE 15 (2006). In 1999, E.U. Commission President Jacques Santer and his entire team of commissioners were forced to resign following an independent report into fraud, nepotism, corruption, and mismanagement.

[53] Dinan, *supra* note 47, at 162. For example, British national identity is bound up with a popular acceptance of Britain's parliamentary sovereignty, democracy, common law tradition, religious pluralism, and liberalism. The British like to cling to their sovereignty and see European integration as primarily about trade. French identity became defined in terms of the French state: if there were no French state, there would be no French citizenry and hence no French identity. The French state acted as the main engine of change and was also the embodiment of French sovereignty, power, grandeur, and tradition.

[54] *See* GILLINGHAM, *supra* note 52, at 305. Turnout for elections to the European Parliament has dropped steadily from 63% in 1979 to 49% in 1999. *Id.*; *see also* Dinan, *supra* note 47, at 163.

[55] Sergio Fabbrini, *American Democracy from a European Perspective*, 2 ANN. REV. POL. SCI. 465, 480 (1999).

the authority wielded by the U.S. government with respect to its states has been regulatory.[56]

U.S. democracy arose contractually; it did not have to contend with an absolute state to constitutionalize, nor was it conditioned by scarce resources to be distributed among the growing population. In contrast, E.U. democracy resulted from a series of conflicts between social classes and democratic interest for control of the union.[57] Thus, where the United States' freedom of economic enterprise anticipated the birth, and thereafter guaranteed the growth of political freedom itself,[58] in the E.U., particularly in France and Germany, it was the conquest of political freedom that created conditions for the development of economic freedom.[59] Because of this different sequence, it has been claimed that in the United States, unlike in Europe, a modern market economy was able to develop in a stateless context.[60]

Common thought views U.S. federal power as having always applied equally to the states. However, throughout the nineteenth century, states had been instrumental in promoting economic activity within their territories. Likewise, each state exercised jurisdiction in many policy areas within its own borders. They protected against external encroachment and pursued mercantilistic policies no different from those of many European Member States. This was made possible by the states' control over fiscal resources. Thus, for more than its first century of life, the United States was based on states' rights to initiate, or to not initiate, new tax laws. Only until passage of the Sixteenth Amendment, in 1913, did Congress acquire the "power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."[61]

Segmentation of power along state lines proved to be a constraint on further development of the U.S. market. With Congress largely controlled by state and local interests, and the president lacking sufficient policymaking influence, business organizations quickly learned that cross-border markets do not emerge spontaneously when territorial interests are strong. Between 1875 and 1890, business organizations began to challenge state restrictions, and they

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[56] SEYMOUR LIPSETT, THE FIRST NATION: THE UNITED STATES IN HISTORICAL AND COMPARATIVE PERSPECTIVE 45-54 (1979).

[57] Hans Daalder, *Paths Toward State Formation in Europe: Democratization, Bureaucratization, and Politicization*, *in* POLITICS, SOCIETY AND DEMOCRACY 113-30 (H. E. Chehabi & Alfred Stepan eds., 1995).

[58] ROBERT D. DAHL, DEMOCRACY IN THE UNITED STATES: PROMISE AND PERFORMANCE 96-101 (1967).

[59] *See* THE FORMATION OF NATIONAL STATES AND WESTERN EUROPE x (Charles Tilly ed., 1975).

[60] J. P. Nettl, *The State as a Conceptual Variable*, 24 WORLD POL. 559, 561, 574-80 (1968).

[61] U.S. CONST art. 1, § 8, cl. 1.

pressed courts to challenge the legislation in force.[62] As such, by way of judicial review, the courts assumed a policymaking role.

Because the state courts sided with states' claims to preserve their own tariffs and barriers, it fell to the U.S. Supreme Court to create a single market. Building on the landmark cases *Gibbon v. Ogden*[63] and *Brown v. Maryland*,[64] and utilizing the interstate Commerce Clause, the Supreme Court began dismantling state barriers and thus set a national market agenda. States could no longer discriminate against out-of-state corporations nor could they hinder the cross-border flow of goods. The representation of state interest was not allowed to sabotage the consolidation of a national market.

Whereas the court was crucial for the building of a U.S. national market, legislative and executive decisions initially established the E.U. market. The European Member State was an economic actor per se, rather than the creator of the institutional conditions for a market economy. The United States' path was conducive to a political system organized around multiple separations of power.[65] In contrast, the path taken by the E.U. was favorable to political ideologies characterized by a system centered around parliament and whose decision-making was determined by the preferences of its government and ruling parliamentary majority.

However, the likenesses between the construction of the U.S. and European single markets are clear. Similar to the American experience of market building, the European Court of Justice (ECJ) played a critical role in establishing the legal foundations necessary for the single market to emerge. In fact, it has been argued that the E.U. has been governed by judges.[66] In the second half of the twentieth century, the ECJ has neutralized Member State barriers and thereby has allowed the E.U.'s institutions to fill the void with positive rules on integration.[67]

The ECJ resolves legal disputes that arise between the various E.U. institutions, between E.U. institutions and the Member States, and between the Member States themselves. The ECJ also provides authoritative interpretations of European law to national judges. The fifteen members of the ECJ (which sits in Luxembourg) are appointed by the Member States and serve renewable six-year terms.[68] In the years when the E.U. seemed to be dormant, the ECJ extended its reach deep into the national laws of the Member States. In a series of landmark

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[62] MICHELLE EGAN, CONSTRUCTING A EUROPEAN MARKET: STANDARDS, REGULATION AND GOVERNANCE 35 (2001).

[63] 22 U.S. 1 (1824).

[64] 25 U.S. 419 (1827).

[65] *See* Sergio Fabbrini, *The American System of Separated Government: An Historical Institutional Interpretation*, 20 INT'L POL. SCI. REV. 95, 112-13 (1999).

[66] ALEC STONE SWEET, GOVERNING WITH JUDGES: CONSTITUTIONAL POLITICS IN EUROPE 153-63 (2000).

[67] EGAN, *supra* note 62, at 108 (2001).

[68] DEMOCRACY AND FEDERALISM IN THE E.U. AND THE U.S., *supra* note 45, 47-49 (discussing the constitutionalization process with respect to the E CJ).

decisions in the 1960s and 1970s, the ECJ established doctrines that provide the cornerstones of a theory of legal intervention into the relationship between the E.U. and the Member States.[69] However, in recent years its judicial activism has been called into question.[70] The ECJ's jurisdictional claims remain largely unchallenged and enforceable. Whether this will continue depends upon on the willingness of the Member States' courts to enforce its rulings.[71]

IV. THE FOUR FREEDOMS, TAXATION, AND THE CHALLENGE OF COMING UP WITH ONE SET OF RULES

European integration has primarily concerned economic integration (i.e. focusing on common commercial issues and their related policies). As a result, the E.U. has not been able to successfully work toward fiscal integration. Most decisions about E.U. spending are made by the Member States. Its spending budget amounts to only 1.5% of the E.U.'s gross domestic product (GDP), compared to the U.S. federal budget of approximately 35% GDP.[72] Also, unlike the United States, where there is a sharing of pooled revenues, there are no fiscal transfers and no inter-jurisdictional transfer funds in the E.U. These issues stem from the fact that the E.U. has almost no taxing authority, but instead receives subsidies from the Member States. In fact, the E.U. has less taxing and spending

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[69] *See* Donna Starr-Deelen & Bert Deelen, *The European Court of Justice as a Federator*, 26 PUBLIUS 84-86 (1986). The court held in 1963 that treaty provisions could have "direct effect," thus allowing individual citizens to sue national governments in their own national courts for non-enforcement of the treaty. *Id.* at 84 (citing Case 26/62, Van Gend en Loos v. Nederlandse Administratie dr Belasting, 1963 E.C.R. 1). In 1964, it established the supremacy doctrine, in which the court determined that state transfers of legal powers were irreversible and a permanent limitation on sovereign rights. *Id.* at 84-85 (citing Case 6/64, Costa v. ENEL, 1964 E.C.R. 585). The preemption doctrine, developed in several cases, holds "that when community law substantially regulates an area, it preempts national legislation in that area except where EC law provides otherwise." *Id.* at 85. Finally, the judicial review doctrine, also established in several cases, enables the court to determine the constitutionality of executive and legislative acts of government and to define their respective rights and powers. *Id.* at 86.

[70] *Id.* at 81-97. *See also* Hjalte Rasmussen, *Between Self-restraint and Activism: A Judicial Policy for the European Court,* 13 EUR. L. REV. 128, 138 (1988), (stating "in the attempt to 'make Europe' the European Court went too far too often [and] in defiance of much European tradition . . . engaged in a teleological crusade, the banner of which featured a deep involvement [that] led it to give primacy to pro-integrationist public policies over competing ones that were often even outside of the ring of losing litigants, considered as meriting some protection"); Kris Pollet, *EU Lawmaking: Less, Better and Simpler*, 2 EUR. POL. ANALYST 63 (1996) (discussing how the Treaty of European Union placed limits on the ECJ).

[71] *See* Alan Riley, *The ECJ: A Court with a Mission?,* 4 EUR. POL. ANALYST 69, 76 (1996).

[72] Dinan, *supra* note 47, at 149.

authority than national governments, state, and federal unions, or even some municipalities.[73] Because Member States are reluctant to cede the power to tax, repeated attempts to reform revenue-raising and spending practices have been overwhelmingly rejected.

The Four Freedoms—goods, persons, services, and capital[74]—place the different national systems of the Member States into direct competition by affording those companies dissatisfied with the political/legal/social environment of the Member State they are in the ability to move to another Member State that has adopted a regime which better suits them. This freedom of persons and companies to move has the effect of forcing the national systems to compete to produce the best results to attract and/or retain valuable capital and labor assets. Furthermore, the free movement of capital and the free movement of companies under the right of establishment have a capacity to affect how capital is provided and organized within the E.U.

In cross-border situations, taxation continues to be "one of the fundamental, sacrosanct bastions of national sovereignty."[75] As acknowledged by the ECJ, Member States are "not obliged therefore to adapt their own tax systems to the different systems of tax of the other Member States."[76] Member States are able to exercise fiscal sovereignty[77] to determine the tax unit,[78] the tax base,[79] the tax rate, and how they wish to administer, assess, collect, and recover tax.[80] However, although the existence of tax law is a matter for Member State competence, how the Member State decides to exercise that competence is subject to union law and is often problematic.[81]

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[73] JOHN GILLINGHAM, EUROPEAN INTEGRATION 1950-2003 124 (2003).

[74] *See supra* Part I.C.

[75] Suzanne Kingston, *The Boundaries of Sovereignty: The ECJ's Controversial Role Applying Internal Market Law to Direct Tax Measures,* 9 CAMBRIDGE Y.B. EUR. LEGAL STUD. 287 (2007).

[76] Case C–67/08, Block v. Finanzamt Kaufbeuren, 2009 E.C.R. I–883, para. 31.

[77] Case C–298/05, Columbus Container Servs. BVBA & Co. v. Finanzamt Bielefeld-Innestadt, 2007 E.C.R. I–10451, para. 53.

[78] Those over whom the Member State wished to assert legislative fiscal jurisdiction; usually those resident in the Member State and the profits which arise in that state.

[79] For example, the nature and amount of the receipts the Member State wishes to tax and the identification of the entitlement to and nature of tax reliefs.

[80] *See* JULIAN GHOSH, PRINCIPLES OF THE INTERNAL MARKET AND DIRECT TAXATION 1-14 (2007). *See also* Case C–374/04, Test Claimants in Class IV of the Act Grp. Litig. v. Comm'rs of Inland Revenue, 2006 E.C.R. I–11673, para. 50 ("It is for each Member State to organize, in compliance with the union law, its system of taxation of distributed profits and, in that context, to define the tax base as well at the tax rates which apply to the company making the distribution and/or the shareholder to whom the dividends are paid, in so far as they are liable to tax in that state.").

[81] *See, e.g.*, Case C-246/89, Comm' v. U.K., 1991 E.C.R. I-4585.

In the E.U., the basic rule governing the free movement of capital is found in Article 63 of the Treaty of the Functioning of the European Union (TFEU), which prohibits "all restrictions on the movement of capital between Member States and between Member States and third countries."[82] However, the Member States can impede this free movement under the expressed derogations in Article 65(1)(A) TFEU which permits Member States "to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested."[83] Meanwhile, Article 65(1)(B) TFEU allows them "to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudent supervision of financial institutions."[84] Thus, the treaty sends mixed messages by allowing Member States the liberal movement of capital and national tax autonomy.

With respect to the freedoms of capital and establishment, the ECJ tended to use a formula based on removing hindrances, obstacles, or restrictions,[85] which was justified by reference to the express derogations as well as the broader justifications.[86] This was demonstrated in *Lankhorst–Hohorst*[87], which concerned the German thin capitalization rules.[88] Under these rules, a resident subsidiary company's loan repayments to a nonresident parent were treated as dividend payments and subject to tax in the resident subsidiaries' hands. Had these repayments been made to a resident parent company, they would have been tax-deductible by the subsidiary. The ECJ, without reference to the distinction between resident and nonresident companies, said the rules constituted an unjustified obstacle to the freedom of establishment because they made it "less attractive for companies established in other Member States to exercise freedom of establishment and they may, in consequence, refrain from acquiring, creating or maintaining a subsidiary in the state that adopts the measure."[89] However, there is

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[82] Treaty on the Functioning of the European Union art. 63, art. 63, Oct. 26, 2012, 2012 O.J. (L. C.326) 1977-091X [hereinafter TFEU].

[83] *Id.* art. 65(1)(A).

[84] *Id.* art. 65(1)(B).

[85] *See* Malcolm Gammie, *The Role of the European Court of Justice in the Development of Direct Discrimination in the European Union*, 57 BULL. FOR INT'L PHYSICAL DOCUMENTATION 86 (2003).

[86] Axel Cordewener et al., *The Clash Between European Freedoms and the National Direct Tax Law: Public Interest Defenses Available to the Member States*, 46 COMMON MKT. L. REV. 1951 (2009).

[87] Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-100829, para. 49 (discussing a "restriction on freedom of establishment," and a broad, restriction-based approach); *See also* Case C-168/01, Bosal Holding v. Staatssecretaris van Financien, 2003 E.C.R. I-9409, para. 27 (stating "a parent company might be dissuaded from carrying on its activities through a subsidiary established in another state.")

[88] Thin capitalization occurs when a company's capital consists disproportionately of debt rather than equity, causing it to be too highly leveraged.

[89] *See Lankhorst-Hohorst*, 2002 E.C.R. I-100829, para. 32.

an inherent tension between this "restriction approach" and the taxation regimes in the Member States which differ significantly with respect to tax rates, tax bases, and accounting rules, which litigants began to exploit.[90] The problem is that the ECJ refuses to accept pure economic justifications. Unfortunately, the justification for levying tax, the Member States' principal source of revenue for funding public and other essential services, is essentially economic.

Further, nearly all national tax laws are adopted for economic reasons and are liable to deter cross-border movement. For example, consumer protection measures adopted by the home Member State often protect the consumers in the host country. However, revenue collection by one Member State in no way protects the physical interest of another. Under the traditional mutual recognition approach that supports much of the E.U. case law, the ECJ at one time considered those tax laws unjustified restrictions and sought to overturn them.

The ECJ's approach in addressing freedom of capital and establishment issues resulted in substantial losses to national treasuries,[91] leading Member States to express serious doubt about the courts' interference in this area.[92] Questions arose regarding the legitimacy of whether or not the ECJ could trespass in this area of Member State sovereignty and, if so, should apply its single market case law, based on a restrictions analysis, to an area with long-established, internationally-recognized principles based on a discrimination model. Member States resisted relinquishing sovereignty due, in large part, to the complexity of taxation, the potentially substantial financial consequences of the decisions made

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[90] *See, e.g.*, Case C-196/04, Cadbury Schweppes Plc v. Comm'rs of Inland Revenue, 2006 E.C.R. I-7995.

[91] Kingston, *supra* note 75, at 287. When the court struck down the national rule in *Bosal* it was estimated that the direct cost of the case amounted to €1.2 billion between 2003 and 2010. *Id.* at 301. Even after changing its legislation it is estimated that the cost to the Netherlands was €.55 billion a year to comply with the judgment. *Id.*

[92] This was recognized by European Commissioner Kovacs:

> But several member states feel that the court does not have sufficient regard in decisions to specific national policies and particularly to the financial consequences of its judgments. . . . In particular, I am not happy with the fact that the EU tax policy is increasingly being made as a result of Court decisions rather than as a result of coordinator policy actions of Member States. I am convinced that the recent developments in this area could lead to a situation where it will become almost impossible for member states to protect the tax bases at national level.

Laszlo Kovacs, Eur. Comm'r for Taxation and Customs, The Future of EU Taxation Policy, Speech to Tax Directors' Institute and to PricewaterhouseCoopers (Dec. 8, 2005), *available at* http://ec.europa.eu/taxation_customs/resources/documents/common/about/speeches/51201tdi.pdf. *See also* TFEU, *supra* note 82, art. 65(4), which was seen as a direct rebuff to the court.

with respect to it, and the lack of judicial expertise.[93] Member States perceived the risk of significant tax base corrosion and catastrophic revenue losses if autonomy was surrendered to the E.U.[94] The international tax law community has provided some support for Member States' assertions with many within the community critical of the ECJ's case law.[95]

Subsequently, the ECJ has proven receptive to the concerns of the Member States and has become more accommodating in the field of taxation.[96] Member States that had previously lost virtually all tax cases started winning again.[97] The ECJ altered the course of its jurisprudence, in particular toning down the language of tax restrictions.[98] Now, in the field of tax barriers a different approach prevails,[99] despite the fact that double taxation "is the most serious

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[93] *See* Michael J. Graetz & Al C. Warren, Jr., *Dividend Taxation in Europe: When the ECJ Makes Tax Policy*, 44 COMMON MKT. L. REV. 1577 (2007) for an example of the complexity in the area of dividend taxation.

[94] *See, e.g.*, Case C-446/04, Test Claimants in the FII Group Litig. v. Comm'rs of Inland Revenue, 2006 E.C.R. I-11753, para. 222; Case C-292/04, Wienand Meilicke v. Finanzamt Bonn-Innenstadt, 2007 E.C.R. I-1835, para. 61.

[95] *See* Peter J. Wattel, *Red Herrings in Direct Tax Cases Before the ECJ,* 31 LEGAL ISSUES OF ECON. INTEGRATION 81 (2004).

[96] Georg W. Koffler & Ruth Mason, *Double Taxation: A European "Switch in Time"?*, 14 COLUM. J. EUR. L. 63, 91-94 (2007) (describing how this has been brought about due to Member States' inactivity and failure to adopt union legislation to deal with the matter).

[97] Suzanne Kingston, *A Light in the Darkness: Recent Developments in the ECJ's Direct Tax Jurisprudence*, 44 COMMON MKT. L. REV. 1321, 1335-36 (2007); BEN J.M. TERRA & PETER J. WATTEL, EUROPEAN TAX LAW 725-26 (2d ed. 2008).

[98] *See* Case C-374/04, Test Claimants in Class IV of the ACT Grp. Litig. v. Inland Revenue Comm'rs, 2006 E.C.R. I-11673 paras. 37-40 (ruling, based on the free movement of capital, together with the right of establishment, that a distinction should be drawn between quasi-restrictions and true restrictions in the context of tax, where true restrictions can and should be analyzed only under the discrimination approach). Therefore, if the rule is truly nondiscriminatory it will not breach the treaties. *Id. See also* Case C-524/0410 Test Claimants in Thin Capitalization Grp. Litig. v. Inland Revenue Comm'rs, 2007 E.C.R. I-2107, para. 48.

[99] Movement towards a discrimination-based approach can be found in ACT, 2006 E.C.R. I-11673. ACT concerned outgoing dividends paid by a U.K. subsidiary to a non-U.K. parent. Consistent with the principles of international taxation outlined above, the non-U.K. parent was not liable for U.K. tax on the dividends but nor was it entitled to a U.K. tax credit on those dividends. By contrast, U.K. parents receiving upstream dividends from U.K. subsidiaries would have received a tax credit for the ACT paid by the U.K. subsidiary. The court found that the U.K. rules were compatible with article 49. The court said that the situation of the U.K. parent and a non-U.K. parent would not be comparable because the non-U.K. parent was not subject to the tax charge while the U.K. parent was subject to the tax charge. *See also* Case C-196/04, Cadbury Schweppes Plc v. Comm'rs of Inland Revenue, 2006 E.C.R. I-7995.

obstacle there can be to people and their capital crossing internal borders."[100] However, distrust of the ECJ and among the Member States themselves persists when it comes to deciding on tax matters and the willingness to curtail the free movement of capital and services.[101]

V. HYBRID FINANCE AND THIN CAPITALIZATION IN THE E.U. CONTEXT

This part begins by (1) discussing the issues related to the characterization of hybrid instruments under domestic law before (2) addressing some recent trends in thin capitalization legislation that influence this characterization.

A. Characterization of Hybrid Instruments under Member States

1. In General

Prior literature and ECJ case law considers characterization of hybrid instruments the discretion of the Member States not constituting discrimination against or restriction of the Four Freedoms.[102] However, the tax treatment of payments on hybrid instruments is affected by the directives. From an intra-group standpoint, the classification of the payments made on, or received from hybrid instruments as either dividends or interest is particularly important as they are likely to receive different treatments under domestic law and bilateral tax treaties. The classification is also relevant in relation to the determination of the application of the Interest and Royalties Directive and/or the Parent Subsidiary Directive, or if neither apply. The analysis of the classification of hybrid instruments and their yield under double tax treaties is beyond the scope of this article.

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[100] Case C-376/03, D. v Inspecteur van de Belastingdienst, 2005 E.C.R. I-5821, para. 85 (Oct. 26, 2004) (opinion of Advocate General Ruiz-Jarabo Colomer).

[101] *See* Martha O'Brien, *Taxation and the Third Country Dimension of Free Movement of Capital in EU Law: The ECJ's Rulings and Unresolved Issues*, 6 BRIT. TAX REV. 628, 661-62 (2008).

[102] *See, e.g.*, Eberhartinger & Six, *supra* note 7; MARJAANA HELMINEN, THE DIVIDEND CONCEPT IN INTERNATIONAL TAX LAW 266 (1999); Case C-319/02, Petri Manninen v. Finland, 2004 E.C.R. I-7477; Case C-315/02, Anneliese Lenz v. Finanzlandesdirektion fur Tirol, 2004 E.C.R. I-7063; Case C-168/01, Bosal Holding BV v. Staatssecretaris van Financien, E.C.R. I-9409; Case C-321/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-100829.

2. The Concept of the Hybrid Financial Instrument

Rather than focusing on pure equity or debt instruments, this article highlights the characterization problem of the vast majority of financial instruments: their hybrid nature. Defining what a hybrid instrument consists of is important to understanding the issues that the use of such instruments raises in cross-border transactions.

A hybrid instrument can be defined as a "financial instrument that has economic characteristics that are inconsistent, in whole or in part, with the classification implied by its legal form."[103] Authors usually classify the basic hybrid instruments into "preference shares, redeemable preference shares, participation loans, *jouissance* rights, silent partnerships—typical or atypical—participation bonds, convertible bonds, warrant bonds, subordinated long term and perpetual indebtedness, and subordinated debt," with a considerable development of "'exotic' derivatives, through the combined use of options, forwards and swaps, such as credit default swaps or credit default options."[104] As mentioned above, such financial instruments generally possess characteristics falling under more than one single tax classification or may not be assigned to any classification at all. They enable tax practitioners to design a kind of transaction with disparate international tax treatment with respect to the "deductibility, inclusion, timing, or character of payments made."[105] It might, for example, either refer to convertible or participating debt obligations, which bear the denomination of indebtedness, but have substantial equity features. Newer products often involve payments based on the value of property not traditionally associated with debt obligations. In addition to the issue of classification as debt or equity, this second category poses the problem of whether a particular instrument should be classified as a forward contract or other financial product that may not be characterized as either debt or equity. Hybrid instruments also encompass instruments that involve entirely conventional terms, but raise classification issues because they fall on the borderline between debt and equity. The focus of this study points toward this last category.

Although clearly an important factor, tax planning does not necessarily appear as the main concern in creating new hybrid financial instruments. Rather, it seems to be "the desire of issuers to raise capital in a cost-efficient manner"[106] that principally lies beneath such development. Whatever the incentive of the investor or issuer might be, it remains that as a result of its hybrid features, this type of financial instrument will trigger differences in treatment for purposes of

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[103] James A. Duncan, *Tax Treatment of Hybrid Financial Instruments in Cross-border Transactions*, *in* 85a CAHIERS DE DROIT FISCAL INT'L 22 (2000).

[104] Francisco A. Garcia Prats, *Qualification of Hybrid Financial Instruments in Tax Treaties* 8 DIRITTO E PRATICA TRIBUTARIA INTERNAZIONALE 977, 981 (2011).

[105] Peter J. Connors & Glenn H.J. Woll, *Hybrid Instruments – Current Issues*, 553 PLI/TAX 175, 181 (2002).

[106] Duncan, *supra* note 103, at 23.

corporate law, accounting, regulation, and taxation. This pattern is even sharper due to the differences in definitions that continue to exist between countries.

B. Thin Capitalization Policy

1. In General

The concept of thin capitalization relates to a company's proportion of debt and equity capital. A company is usually said to be thinly capitalized whenever its proportion of debt capital in relation to its equity capital is high.[107]

Within the European Union, the path towards a thin capitalization policy is most associated with the 2002 ECJ *Lankhorst-Hohorst* case.[108] The ECJ decided that the German thin capitalization rule introducing a domestic preference was invalid. As a result of this decision, thin capitalization domestic legislation is not exempt from complying with E.U. law. One of the main issues that emerged with the introduction of thin capitalization rules is the risk of non-conformity with the non-discrimination principles.

Prior to the *Lankhorst-Hohorst* case, thin capitalization legislation usually applied to inbound transactions only, therefore creating a difference in treatment between domestic and foreign (E.U. and non-E.U.) companies. The obligation to comply with non-discrimination principles, coupled with the divergence of treatment of thin capitalization among the Member States, urged commentators to advocate for the harmonization (or at least the scope) of thin capitalization rules.[109] Hence, when "[f]aced with the opportunity of 'harmonizing up' or 'harmonizing down' [i.e., extending benefits previously allowed only to domestic companies to foreign companies as well, or, instead, also restricting benefits for domestic corporations] most European countries, other than Spain, have, so far, opted to harmonize down."[110] Undoubtedly, such a trend towards harmonization within the limits of a Member State does not resolve the problem of discrepancies within the European Union. The only viable solution would then be the introduction of a common E.U. definition of thin capitalization, and/or of a set of thin capitalization rules. Although it does not directly address

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[107] *See* INT'L BUREAU FOR FISCAL DOCUMENTATION (IBFD), INTERNATIONAL TAX GLOSSARY 441 (5th ed. 2005).

[108] Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-100829, at para. 34.

[109] *See e.g.*, Nikolaj Vinther & Erik Werlauff, *The Need for Fresh Thinking About Tax Rules on Thin Caitalization: The Consequences of the Judgment of the ECJ in Lankhorst-Hohorst*, 2 EC TAX REV. 97, 106 (2003); Otmar Thoemmes, et al, Thin Capitalization Rules and Non-Discrimination Principles, 32 INTERTAX 126, 136-37 (2004).

[110] William H. Morris, *European Tax Policy*, 33 INT'L TAX J. 35 (2007).

thin capitalization, the proposed Common Consolidated Corporate Tax Base[111] (CCCTB) might finally provide a solution.[112]

Rather than providing a thorough analysis of Member States' thin capitalization legislation, this part seeks to provide an overview of the policy trends across the European Union. The implications of these thin capitalization or "earnings stripping" rules are of particular importance as far as cross-border business expansion is concerned since "debt is a critical instrument of growth—allowing for much greater growth than would simple reliance on equity."[113]

The use of hybrid financing is intrinsically linked to the tax-minimizing decisions undertaken by companies in cross-border transactions. They may directly or indirectly fall within the scope of domestic thin capitalization rules, or may be taken into account in computing a safe haven. Because of the complexity of their characteristics, classification of hybrid instruments or of their yield as either debt or equity is more often than not a difficult task for the countries concerned. Whether or not characterization rules are included in domestic law—sometimes with characterization rules applying specifically to thin capitalization—the particular uncertainty derived from the hybrid nature of certain financial instruments makes their use a very attractive means of shifting profit within the group. The consecutive increase in the number and use of hybrid financial instruments has certainly accelerated the global phenomenon of introduction of thin capitalization rules or rules having a similar effect among the OECD countries. Likewise, companies need to have a precise understanding of both characterization and thin capitalization rules to conduct efficient cross-border tax planning and to consider which hybrid instruments to use.

Not all E.U. Member States have enacted mechanisms to fight thin capitalization. Member States may be classified depending on their approach to thin capitalization. Currently, seven Member States do not apply any thin capitalization rules (Cyprus, Estonia, Finland, Greece, Malta, Slovakia, and Sweden).[114] Austria, Germany, Ireland, and Luxembourg have not formally enacted thin capitalization legislation, but apply tax or administrative rules and

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[111] *European Commissionn Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, COM (2011) 121 final (Mar. 16, 2011) [hereinafter CCCTB Proposal].

[112] The introduction of a common thin capitalization rule within the scope of the CCCTB has recently been discussed by the tax literature. *See, e.g.*, Ana P. Dourado & Rita de la Feria, *Thin Capitalization Rules in the Context of the CCCTB*, (Oxford University Centre for Business Taxation, Working Paper No. 08/04, 2008), *available at* http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_08/WP0804.pdf. *See also* Contract Award Notice TAXUD/2007/DE/322 under which the European Commission appointed the Centre for Business Taxation, University of Oxford to conduct a study pointing at the elimination of the differences of characterization and treatment of debt and equity.

[113] Morris, *supra* note 110, at 35.

[114] Otmar Thoemmes et al., *Thin Capitalization Rules and Non-Discrimination Principles*, 32 INTERTAX 126, 127 (2004).

regulations of similar effect. The German example is interesting in many regards. First, although Germany had implemented thin capitalization rules since 1994,[115] it repealed these rules in favor of an "earnings stripping" rule.[116] The new rule, which states its main goal is "to encourage financing by equity instead of debt capital,"[117] is *de facto* much more restrictive than the former thin capitalization legislation. This is in line with the intent of the German parliament to stop the shifting of profits abroad.[118] Second, and in general terms, interest paid by a German taxpaying company in excess of 30 percent of the taxable EBITDA (Earnings before interest, taxes, depreciation, and amortization) is non-deductible. The novelty is that the new rules apply to all debt financing—including bank financing—and to both German and non-resident companies irrespective of whether they actually generate business or non-business income in Germany. Any disallowed interest expense may be carried forward indefinitely as long as it does not exceed a 30 percent threshold.

Finally, a majority of Member States has introduced specific thin capitalization rules, which "vary according to the method adopted, their scope of application, and their effect."[119] The most common method is to cap interest deductions. Among the Member States having adopted such a scheme is France. In the aftermath of the *Lankhorst-Hohorst* ruling, mixed, non-traditional regimes have emerged. One interesting example is that of the United Kingdom. There, the particular issue of intra-group lending is assimilated to that of transfer-pricing.[120] Under the U.K. regime, there is no fixed debt-to-equity ratio, and thin capitalization is asserted on a case-by-case basis. In addition, a thinly capitalized company benefits from a safe harbor if it shows that the loan undertaken was made under arm's length conditions.[121]

In contrast to the above policies are the guidelines enacted by Belgium and the Netherlands. Belgium has enacted a method consisting of stimulating corporations to increase equity by applying to equity contributions a notional interest deductible by the corporation. This notional interest is computed as a percentage of the corporation's equity and consequently limits one of the most appealing tax aspects of using debt. On the other hand, the Netherlands applies a

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[115] Germany amended its thin capitalization legislation in 2001, 2003, and finally in 2004 following the *Lankhorst-Hohorst* ruling.

[116] Introduced in the UNTERNEHMENSSTEUERREFORM 2008 [CORPORATE TAX REFORM 2008 ACT], July 6, 2007.

[117] *Id*.

[118] *See* Stefan Ditsch & Barbara Zuber, *Germany: 2008 World Tax Supplement*, 18 INT'L TAX REV. 190 (2007).

[119] Dourado & de la Feria, *supra* note 112, at 4.

[120] The Finance Act of 2004 repealed *stricto sensu* thin capitalization rules to integrate them as part of the transfer pricing regime.

[121] *See e.g.*, Peter Bater, *United Kingdom*, IBFD EUR. TAX SURVEYS; Jefferson VanderWolk, *Finance Act Notes: Transfer Pricing and Thin Capitalization – Sections 30-37 and Schedule 5*, 5 BRIT. TAX REV. 465, 468 (2004); A.K. Rowland, *Thin Capitalization in the United Kingdom*, 49 BULL. FOR INT'L FISCAL DOCUMENTATION 554 (1995).

tax rate and a deduction rate identical to intra-group input and output of interest. This mechanism has the effect, with respect to the borrowing corporation, to equate the tax treatment of debt interest with that of dividends. In regards to the lending corporation, the tax rate applied to the interest received is relatively low.

In 2010, the European Union Council adopted a resolution coordinating the rules regarding controlled foreign corporations and thin capitalization within the European Union.[122] This resolution was justified by the diversity of the mechanisms aimed at protecting the tax base of the Member States that, due to protectionism and tax evasion concerns, could have indirectly resulted in tax treatment differences depending on the domicile or nationality of a company. While acknowledging the necessity—invoked by the Member States—to fight thin capitalization, the European Union Council recalled that the national measures must not conflict with the freedoms guaranteed by the Treaties of the European Union and the arm's length standard. The resolution also suggests, and prompts the Member States to implement, criteria evaluating the thin capitalization ratio of a corporation. Such a criterion had been introduced by France in its *Loi de Finances* for 2006.[123]

2. Categorization of the European Legal Framework of Thin Capitalization

When a taxpayer is looking for intra-group financing, the issuer is often inclined to finance its business activities with the use of debt instruments rather than equity. This incentive arises out of the search for reducing the tax base of the debtor by offsetting the deductible interest expense against its taxable income. Nonetheless, particular group strategies are also likely to reduce the interest income at the level of the creditor, for example, in the case of "availability of tax losses at the level of the creditor and no or limited taxation of the remuneration on the instrument at the creditor level based on hybrid features."[124]

One of the main tax-related issues, as far as corporate finance is concerned, is the classification of the instruments available to taxpayers to finance their businesses as either debt or equity. Where characterized as equity for tax purposes, the remuneration on these instruments is dividends. In most Member

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[122] Council Resolution of 8 June 2010 on Coordination of the Controlled Foreign Corporation (CFC) and Thin Capitalization Rules Within the European Union, 2010 O.J. (C 156) 1.

[123] Regarding French Law, see BERNARD CASTAGNEDE, PRÉCIS DE FISCALITE INTERNATIONALE [SUMMARY OF INTERNATIONAL TAXATION] (2d ed. 2020); Sebastien de Mones et al., *Sous-capitalisation: projet d'extension du régime aux prêts garantis par une societe du group* [Undercapitalization: proposed extension of the scheme to guarantee loans by a company group], QUESTIONS D'ACTUALITES - FR 47/10, Nov. 19, 2010.

[124] T.J.C. van Dongen, *Thin Capitalization Legislation and the EU Corporate Tax Directives*, 52 EUR. TAXATION 20, 20.

States, this means that they are not deductible by the distributing entity, although "partial relief from economic double taxation, by either the exemption or credit method, is generally available at the level of the shareholder."[125] On the other hand, Member States generally provide deductibility of interest at the level of the payor.

The incentive and trend toward corporate hybrid financing and excessive debt has left Member States with the necessity to enact thin capitalization rules. The implementation of such domestic legislation is a direct consequence of the reduction in tax base provoked by excessive debt financing in the country of residence of the debtor. These counter measures introduce thin capitalization ceilings which, when surpassed, lead to the denial of the tax characterization as debt of the instrument, resulting necessarily in an equity characterization.

There are several ways to classify the various thin capitalization legislation implemented by the E.U. Member States. One way consists of dividing these rules into their most common approaches. Where cross-border transactions are involved, thin capitalization legislation falls under either an arms' length principle[126] or a debt-to-equity fixed ratio; undeniably the most forthright approach. The current analysis of thin capitalization legislation also shows that a hybrid policy is sometimes enacted, combining the arm's length principle and settling a fixed debt-to-equity ratio used as safe harbor.[127] In addition, the OECD adopted a classification based on the distinction between fixed and flexible thin capitalization rules. The first category relates to the use of a fixed debt-to-equity ratio, while the second incorporates domestic legislation that takes into account the taxpayer's individual circumstances.[128] As with most rules, thin capitalization legislation also establishes exceptions, among which are those applied "on the basis of the size of either the transaction (. . . *e.g.* France), or the overall turnover (. . . *e.g.* Italy); and those excluding financial institutions from the scope of the general rules, *e.g.* Hungary and Latvia."[129]

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[125] *Id. See also* Case C-194/06, Staatssecretaris van Financien v. Orange European Smallcap Fund, (2008) E.C.R. I-3747, paras. 37-41. In international tax law, the general rule is that priority of taxation lies with the home state to alleviate the double taxation. However, given the principle of fiscal sovereignty, the home state is not obliged to alleviate the double taxation, nor is it required to do so under union law.

[126] Amongst E.U. Member States, only the United Kingdom (since 2004) currently applies the arm's length principle. Under this method, the financing structure considered is compared to the financing structure that would normally be found in a situation involving non-related parties. For a thorough analysis of the use of the arm's length principle in thin capitalization legislation, see Linda Brosens, *Thin Capitalization Rules and EU Law*, 4 EC TAX REV. 188 (2004).

[127] For example, such a hybrid model is encountered in Italy. *See* IBFD *supra* note 107, at 357.

[128] *See* ORGANISATION FOR ECON. CO-OPERATION AND DEV., *Thin Capitalisation; Taxation of Entertainers, Artists and Sportsmen*, *in* 2 Issues in International Taxation 17 (1987).

[129] Dourado & de la Feria, *supra* note 112, at 6.

a. Re-characterization of the Yield Model

The "Re-characterization of the Yield Model" implies that the instrument's yield, solely for tax purposes, will be re-characterized as a dividend, rather than interest. This re-characterization suggests that the instrument's remuneration will generally be non-deductible to the distributing entity (with some exceptions, in particular with respect to wealth taxes). However, a dividend withholding tax might still be implemented. Nonetheless, difficulties may arise in determining the recipient of the dividend given that the holder of the instrument is still considered to be a creditor and not necessarily a shareholder.[130]

b. Non-deductibility of Debt Payments

Under the "Non-deductibility of Debt Payments Model," no re-characterization is involved. Instead, the debtor is simply denied deductibility of interest payments. Consequently, the tax treatment of an instrument and of its remuneration remains unchanged with the only exception being non-deductibility of interest. For example, according to Dutch thin capitalization legislation, interest in excess of a 3:1 debt to equity ratio is not deductible. Dutch law, however, does not apply any withholding tax on outbound interest payments.[131]

In some instances, domestic legislation may apply a mix of both above-mentioned models. The best illustration may be found in Belgian law. In Belgium, two ratios are simultaneously introduced. If the interest payments are in excess of a 1:1 debt to equity ratio,[132] re-characterization of part or all of the interest expense as dividend distributions is applied, therefore denying deductibility of the payments. The second ratio (7:1 debt to equity ratio),[133] when reached, results in the interest payments being denied deductibility without applying any re-characterization.

c. Re-characterization of the Instrument Model

The final model, "Re-characterization of the Instrument," goes beyond the Re-characterization of the Yield Model by changing the character of the

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[130] *See* Organisation of Economic Co-operation and Dev., Commentary on Article 10: Concerning the Taxation of Dividends, Paras 24, 35, 30, 31, Aug. 6, 2012 [hereinafter OECD Commentary on Article 10]; Organisation of Economic Co-operation and Dev., Commentary on Art. 11: Concerning the Taxation of Interest, paras 18-19, Aug. 6, 2012 [hereinafter OECD Commentary on Article 11].

[131] Dutch Corporate Income Tax Act, art. 10d.

[132] WETBOEK VAN DE INKOMSTENBELASTINGEN (Belgian Income Taxes Code), art. 18.

[133] *Id.* art. 198(11).

instrument itself, rather than only its yield. When an instrument is deemed equity, the classification of the holder itself is modified for tax purposes. The holder is deemed a shareholder.

In addition to purely domestic thin capitalization legislation, the E.U. has introduced certain measures which affect hybrid instruments. These rules are found in particular in two directives: the Interest and Royalties Directive[134] and the Parent Subsidiary Directive.[135]

VI. APPLICATION OF E.U. LAW TO HYBRID FINANCE

For purposes of this article, this part is restricted to the most relevant E.U. legislative mechanisms in the area of hybrid finance and thin capitalization: the Interest and Royalties Directive on one hand (Subpart A), and the Parent Subsidiary Directive on the other (Subpart B). It should be noted that, although the 2011 Common Consolidated Corporate Tax Base (CCCTB) proposal would be relevant in this part, it will be addressed in the next section of this article as this section addresses currently enacted law.

A. The Interest and Royalties Directive

The Interest and Royalties Directive introduces common rules applicable to interest payments made between associated companies located in different Member States. The aim is to prevent and eliminate discrimination against intra-community associated companies in comparison to domestic associated companies. To reach this objective, the Interest and Royalties Directive provides that interest payments should only be taxed once and only at the level of the residence state of the creditor. As a result, the source state should refrain from taxing the interest payment.[136]

1. Scope of the Interest and Royalties Directive

Pursuant to Article 3 of the Interest and Royalties Directive, in order for this directive to apply, the companies should be "associated." Under Article 3(1)(b), a company is associated with another if: (1) it directly owns at least 25 percent of the capital of the other company, (2) the other company directly owns at least 25 percent of the capital of the first company, or (3) a third company directly owns at least 25 percent of the capital of both the payor company and the

134 Council Directive 2003/49, 2003 O.J. (L 157) 49 (EC).
135 Council Directive 90/435, 1990 O.J. (L 225) (EEC).
136 Council Directive 2003/49, *supra* note 134, art. 1(1).

receiving company.[137] The directive introduces a minimum holding percentage of 20, which (as will be discussed in Subpart B) differs from the 10% holding threshold required under the Parent-Subsidiary Directive.[138] The spectrum covered by the Interest and Royalties Directive is also broader than that of the Parent Subsidiary Directive, in the sense that it covers both parent-subsidiary and sister relationships.

Pursuant to Article 1(4) of the Directive, an associated company of a Member State is treated as a "beneficial owner" of interest and royalties to the extent it receives these payments for its own benefit and not as an agent, trustee, or authorized signatory. The definition therein is slightly different than the one contained in the OECD Model. It is, however, globally agreed that the E.U. law concept is autonomous from the same expression under the OECD Model.

2. Definition of Interest and Exclusion of Certain Yield from Hybrid Instruments

Although the Interest and Royalties Directive applies to both types of income, this article will focus on the notion of interest with respect to the application of the Directive to hybrid financial instruments. The definition of the term "interest" under Article 2 of the Directive is similar to that of Article 11 of the OECD Model (except for the exclusion of government securities) and reads as follows:

> The term "interest" means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. In particular, it covers all income from securities, bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment are not regarded as interest.[139]

A priori, the notion of interest under this article is sufficiently broad to include the yield from certain hybrid instruments.[140] However, Article 2 must be read in conjunction with Article 4 of the Interest and Royalties Directive, which grants the source state the right to exclude certain payments from the scope of the Interest and Royalties Directive listed hereinafter:

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[137] *Id.* art. 3(1)(b); *see also* Jakob Bundgard, *Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom Under EU Corporate Tax Directives – Part 1*, 10 EUR. TAX'N 442, 443.

[138] Council Directive 2003/49, *supra* note 134, art. 2.

[139] *Id.* art. 2(a).

[140] *See e.g.*, Bundgard, *supra* note 137, at 444; Marcello Distaso & Raffaele Russo, *The EC Interest and Royalties Directive – A Comment*, 4 EUR. TAX'N 149 (2004).

> 1. The source State shall not be obliged to ensure the benefits of this Directive in the following cases:
>   (a) payments which are treated as a distribution of profits or as a repayment of capital under the law of the source State;
>   (b) payments from debt claims which carry a right to participate in the debtor's profits;
>   (c) payments from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits;
>   (d) payments from debt-claims which contain no provision for repayment of the principal amount or where the repayment is due more than 50 years after the date of issue.[141]

Pursuant to this wording, Member States are allowed to decide which of the four situations is excluded from the scope of the Directive. According to Eberhartinger and Six, this option provides Member States "with a tool to counteract the abuses of the directive, through disguising distributions of profit or returns on the provision of equity as interest within the definition of the directive and to avoid major distortions of the national tax system."[142]

Article 4 of the Interest and Royalties Directive is of main concern regarding the application of the Directive to hybrid instruments. In effect, Member States may decide whether the scope of the Directive encompasses financial instruments that fall under one of these categories. The background of the Directive provides an explanation of the intent behind the inclusion of these exceptions. The commission, commenting on a previous draft of the Interest and Royalties Directive stated that

> Member States are permitted to exclude certain payments which may fall under the notion of interest but which actually have the character of distributed profits, income treated as a return of capital or income from hybrid financing. This could arise, for example, under the provisions of a Double Taxation Convention in force between the Member State where the interest arises and the Member State of the beneficial owner or under the law of the Member State where the interest arises.
>
> Interest that has been re-characterized as distributed profits ought to benefit from the provision of Directive

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141 Council Directive 2003/49, *supra* note 134, art. 4

142 Eberhartinger & Six, *supra* note 7, at 19 (2006).

> 90/435/EEC provided all other requirements of that Directive are met, in order to avoid double taxation of such profits . . . .[143]

Article 4(1)(a) is of particular relevance with respect to thin capitalization legislation. It gives Member States the opportunity to deny the benefits of the Interest and Royalties Directive irrespective of its application in the recipient state. The effect of this Article on thin capitalization provisions that do not re-characterize equity/dividends, but instead deny the deductibility of payments, remains uncertain.[144]

Furthermore, Eberhartinger and Six believe that Article 4(1)(b), read in combination with the Parent Subsidiary Directive, has the potential to give Member States the opportunity to fully exclude jouissance rights and silent partnerships from both directives by characterizing them as debt under domestic law.[145] The result would be to exclude these financial instruments from the scope of the Parent Subsidiary Directive, while exempting them from the benefits of the Interest and Royalties Directive through the use of Article 4(1)(b).

The third exclusion documented in Article 4(1)(c) refers to convertible debt instruments that entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits. If interpreted literally, hybrid instruments would not be included. Nevertheless, the reference to the "right to participate in the debtor's profits" is rather ambiguous. If interpreted as equivalent to "right to participate in the debtor's equity," Article 4(1)(c) would then embrace hybrid instruments in the form of convertible bonds or warrant bonds.[146]

Finally, Article 4(1)(d) allows Member States to exclude debt-claims which economically serve as equity. This provision may affect hybrid instruments which are not re-characterized as equity under domestic law, but because of the absence of a repayment date or the settlement of an abnormally long term (over 50 years), have the effect of equity.

The introduction of Article 4(1) is interesting in the sense that it raises opportunities for Member States to implement tax policies that exclude hybrid instruments from the benefits of the Interest and Royalties Directive, irrespective of any further inclusion under the Parent Subsidiary Directive, at least in regards to interest payments mentioned by Articles 4(1)(b) and 4(1)(d). In the case of a characterization inconsistency between the related Member States, hybrid instruments included under these provisions may be subject to double taxation.

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[143] Proposal for a Council Directive on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Associated Companies of Different Member States, at 8, COM (1998) 67 final (internal citation omitted).

[144] *Cf.* Michele Gusmeroli, *Triangular cases and the Interest and Royalties Directive: untying the Gordian knot? – Part 2*, 2 EUR. TAX'N 39, 44 (2005).

[145] Eberhartinger & Six, *supra* note 7, at 24.

[146] *See* Distaso & Russo, *supra* note 140, at 150.

B. The Parent Subsidiary Directive

The Parent Subsidiary Directive was introduced as part of the legislation aimed at ensuring the effective functioning of the common market.[147] The main purpose of the Parent Subsidiary Directive is the elimination of double taxation upon the distribution of profits (dividends) from a subsidiary to its parent in a purely intra-community situation. The directive introduces two means to reach this objective: (1) the abolition of withholding taxes on distributed profits between associated companies in the source state; and (2) the avoidance of double taxation of parent companies on the profits of their subsidiaries.[148] As a practical matter, Member States had to introduce either a tax credit (United Kingdom, Poland, and Malta)[149] or a tax exemption (the remaining Member States) of the dividends received by the parent company.[150] Nevertheless, not all dividends are covered by the Directive. The risk is, therefore, that the distribution may be subject to temporary or permanent double taxation. This risk is magnified because, in the aftermath of the Lisbon Treaty repealing Article 293 of the EC Treaty, E.U. Law has not yet introduced a general obligation to abolish such double taxation.[151] In addition, the Parent Subsidiary Directive only applies to associated companies subject to corporate tax in their respective Member States, and the parent-company must hold directly at least 10% of the capital of the associated company.[152]

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147 *See* CRAIG & DE BURCA, *supra* note 11, at 1170.

148 *See* Council Directive 2003/49, *supra* note 134, art. 2(2). *See also* Distaso & Russo, *supra* note 140, at 145. The Directive also applies to profits paid to or received by a permanent establishment (PE) of a company of a Member State in another Member State. The analysis of the definition of PE under the Directive is beyond the scope of this article.

149 *See* the respective Country Chapters in IBFD EC Corporate Tax Law, (2005).

150 *See* Björkstén Riikjarv & Ulla Linnamagi, Country Chapter Estonia, IBFD EC Corp. Tax Law (2005) recital 786 et seq. Note that Estonia does not subject incoming dividends to corporate tax, but instead taxes the latter when redistributed by the parent company.

151 *See* Case C-513/04, Kerckhaert v. Belgium, 2006 E.C.R. I-10967, para. 22. Where Belgian legislation did not make any distinction between dividends from companies established in Belgium and dividends from companies established in another Member State (France), both dividends were taxed at the same rate and so there was no breach of article 63 (one). The court determined that where there is no discrimination, national laws are compatible with article 63. *See also* Case C-298/05, Columbus Container Servs. BVBA & Co. v. Finanzamt Bielefeld-Innenstadt, 2007 E.C.R. I-10451, para. 40. The court stated that any diverse consequences arising from the Belgian system (the dividends had already been taxed in France, leading to juridical double taxation-the taxation of the same income twice in the hands of the same person) was the result of the exercise "in parallel by two Member States of the fiscal sovereignty." *Id.* para. 43.

152 Council Directive 90/435, *supra* note 135. The holding threshold has been gradually lowered. The current percentage is set as of 1 January 2009. For a definition of Parent Company under the Directive, see *id.* art. 3(1). Note that the term "holding in the capital," *id.* art. 2, is not defined, leaving *a priori* at the Member States discretion the

1. Scope of the Parent Subsidiary Directive

Because hybrid instruments by their nature include debt and equity characteristics, an instrument may be wholly or partially classified as equity while the yield derived from the instrument is characterized as a dividend.[153] The yield may also be deemed a dividend for tax purposes, although the instrument itself retains the character of debt. Such characterization may derive from domestic classification rules or thin capitalization legislation.

It is important to note that only yield on equity falls within the scope of the Parent Subsidiary Directive. Consequently, where the yield is a deemed dividend but the instrument is still considered debt; it is unclear whether the Directive will apply. This situation is likely to appear in Member States which enacted thin capitalization legislation applying the re-characterization of the yield model. A strict interpretation of the Directive's wording would, however, lead to the conclusion of it not applying in this instance. Subsequently, some distributions/payments might be subject to neither the Parent-Subsidiary Directive nor the Interest and Royalties Directive, with the risk of the hybrid financial instrument being taxed twice. The ECJ case law is of little help on this matter as it has not yet ruled on the application of the Parent-Subsidiary Directive with respect to the yield of hybrid financial instruments. Nonetheless, the analysis of the notion of "distribution of profits" might provide some help in determining the applicability of the Directive in relation to hybrid instruments.

2. Notion of "Distribution of Profits"

Some commentators have argued that the term has an autonomous meaning: distinct and independent from any domestic or treaty definition.[154] According to Terra and Wattel,

> the term "distributions" is a Community law expression, to be interpreted autonomously by the ECJ and by the national tax courts in the light of object and purpose of the Directive (and, where appropriate, also in the light of the object and purpose of

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possibility to include or exclude other forms of participation than classic shares in equity. Art. 3(2) also provides exceptions to the holding in capital criterion.

[153] Note that bifurcation of a hybrid instrument is unlikely under E.U. Member States' domestic legislation.

[154] *See e.g.,* TERRA & WATTEL, *supra* note 97, at. 499. *See also* Organisation of Economic Co-operation and Dev., Model Tax Convention on Income and on Capital, art. 10, Jul, 22, 2010 [hereinafter OECD Model]; OECD Commentary on Article 10, *supra* note 130, Para. 23.

> the EC Treaty, notably the Freedoms of establishment and capital movement . . . .[155]

Indirect support for the argument may be found in Advocate General Mischo Opinion regarding the *Lankhorst-Hohorst* case, in which he stated that the characterization of a tax is autonomous from qualification under domestic law. The autonomous argument, although receiving some support,[156] is not fully supported by the literature.[157]

As far as the content of the expression "distribution of profits" is concerned, some clarification has been given by the literature. It is generally understood that the expression has a broader meaning than the term "dividends."[158] According to Bungard and Jakob, the arguments supporting such an interpretation are

> (1) that the term "dividends" could have been used if a narrow scope was intended; and (2) that a broad meaning is in line with the objective of the Directive to avoid economic double taxation of profits received by parent companies from their subsidiaries.[159]

It has also been argued that, because the concept should receive a (partially) autonomous definition, its interpretation should be substantive and economic rather than formal.[160] Accordingly, the expression "distribution of profits" is likely to encompass, along with dividends, any payment made and based on the association between qualifying corporations. Helminen includes all transfers of benefits from one qualifying corporation to another, provided that such transfer is made at no equivalent value or benefit.[161] Terra and Wattel conclude that the expression also covers payments labeled as "interest," but that closely resemble equity.[162] Based on such a broad interpretation, it can be

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155 TERRA & WATTEL, *supra* note 97, at 499.

156 *See, e.g.*, HELMINEN, *supra* note 102, at 73; PAUL FARMER & RICHARD LYAL, EC TAX LAW, 272 et seq. (1994).

157 *See* Cécile Brokelind*, Swedish Supreme Administrative Court Rejects Reference to ECJ Regarding Application of EC Parent Subsidiary Directive*, 45 Eur. Tax'n 327 (2005); *See also* Bundgard, *supra* note 137, at 447. The above-mentioned authors, although not denying the precedence of the autonomous definition theory, acknowledge that there is no agreement in the doctrine on its extent.

158 *See, e.g.*, Bundgard, *supra* note 137, at 448; HELMINEN, *supra* note 102, at 74, 266. *See also* Guglielmo Maisto, *The 2003 Amendments to the EC Parent-Subsidiary Directive: What's next?,* 4 EC TAX REV. 177 (2004); Rudd A. Sommerhalder, *Approaches to Thin Capitalization*, 3 EURO. TAX'N 93 (1996).

159 Bundgard, *supra* note 137, at 448.

160 *See, e.g.*, TERRA & WATTEL, *supra* note 97, at 506.

161 HELMINEN, *supra* note 102, at 74.

162 TERRA & WATTEL, *supra* note 97, at 49.

concluded that "distribution of profits" is likely to include the yield from a hybrid instrument re-characterized as equity by application of thin capitalization legislation, irrespective of any re-characterization of the instrument itself. Yet, because distortions between Member States in classifying hybrid instruments are inevitable, the definition of "distribution of profits" under the Directive should be solely autonomous. In any case, the lack of clear understanding on this notion leaves companies conducting business in the E.U. using hybrid financial instruments uncertain of the application of the Parent Subsidiary Directive.

3. Theoretical Application of the Parent-Subsidiary Directive to Hybrid Financial Instruments

Some presumptions can be made on the methodology that the ECJ is likely to apply to verify whether the yield on a particular hybrid instrument falls within the scope of the Parent Subsidiary Directive. In previous cases, the ECJ has followed a two-step literal/teleological interpretation method.[163] Literal interpretation is first applied and, if room is left for further interpretation, it is done using a teleological methodology.

The overall objective of the Parent Subsidiary Directive as expressed in Paragraph 3 of its Preamble, the elimination of double taxation, should be a central argument towards the inclusion of the yield on hybrid instruments in the scope of the Directive. Indeed, whenever the yield on hybrid instruments is characterized as a dividend or is denied deduction in both the source state and residence state (by way of domestic classification or thin capitalization rules), double taxation would follow as the payments would be subject to corporate tax in both Member States and to withholding tax in the source state. In line with the objective, where the application of domestic legislation results in the yield from hybrid instruments being treated as a dividend by the source state, it should be subject to the Parent Subsidiary Directive. It is interesting to note that the last section of Article 4 of the Proposal for the Interest and Royalties Directive tends to support this conclusion.[164] The interaction of the Interest and Royalties Directive with the Parent-Subsidiary Directive should be read as follows:

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[163] *See, e.g.*, Case C-375/98, Ministerio Publico and Fazenda Publica v. Epson Europe BV, 2000 E.C.R. l-4243, para. 22; Case C-48/07, SPF Finances v. Les Vergers du Vieux Tauves SA, 2008 E.C.R. I-10627, para. 58. For a commentary, see also Bruno Peeters & Anne van de Vijver, *ECJ Rules on Compatibility of Belgian Participation Exemption Regime with EC Parent-Subsidiary Directive*, 4 EC TAX REV. 149 (2009).

[164] *Commission Proposal for a Council Directive on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Associated Companies of Different Member States*, COM (1998) 67 Final [hereinafter *Interest and Royalties directive*]. *See also* Marjaana Helminen, *Classification of Cross-Border Payments on Hybrid Instruments,* 58 IBFD BULL. 56, 60 (2004); Eberhartinger & Six, *supra* note 7, at 21.

> Interest that has been re-characterized as a distribution of profits shall accordingly be subject instead to the provisions of Council Directive 90/435/EEC (The Parent-Subsidiary Directive), where it is paid between companies to which the present Directive applies.[165]

In the context of thin capitalization, a similar conclusion can be reached from the OECD Model Tax Convention. Paragraph 19 of the Commentary on Article 11 provides that "the term 'interest' as used in Article 11 does not include items of income which are dealt with under Article 10" (where Article 10 deals with the treatment of equity).[166] Several authors have recognized the application of the Parent Subsidiary Directive where re-characterization derives from thin capitalization cases.[167]

Furthermore, in a 2009 report of the Commission to the Council,[168] the Commission seems to infer that the Parent Subsidiary Directive applies to the yield from hybrid instruments in the above-mentioned situation (re-characterization as dividend). An International Bureau of Fiscal Documentation (IBFD) Survey reached a similar conclusion.[169] The logical conclusion is that the subjection of the yield from hybrid instruments to one Directive or the other depends on the tax treatment it receives in the source state (or in the tax treaties where applicable).[170] Moreover, arguments point towards the inclusion of disguised dividend payments and re-characterized interest payments under the Parent Subsidiary Directive.

4. Application of the Parent Subsidiary Directive in Case of Characterization Differences

The issue of application of the Parent Subsidiary Directive in cases of characterization inconsistencies arises where the yield from hybrid instruments qualifies as distribution of profits in the source state, but would normally qualify

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165 *Interest and Royalties directive*, *supra* note 164, at 8.

166 OECD Commentary on Article 11, *supra* note 130, para. 19.

167 *See, e.g.*, J. F. Avery Jones et al., *The Definitions of Dividends and Interest in the OECD Model: Something Lost in Translation?*, 1 WORLD TAX J. 38 (2009); O. THOMMES & E. PUKS, EC CORPORATE TAX LAW 12 (Amsterdam: IBFD) (regarding Sec. 6.1, in which the authors conclude to the application of the Directive to disguised profits); Bundgard, *supra* note 137, at 453.

168 Report from the Commission to the Council in Accordance with Article 8 of Council Directive 2003/49/EC on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Associated Companies of Different Member States, at 8, COM (2009) 179 Final.

169 W.F.G. WIJNEN, SURVEY OF THE IMPLEMENTATION OF THE EC CORPORATE TAX DIRECTIVES 363 (1995).

170 *See* HELMINEN, *supra* note 102 at 60; Eberhartinger & Six, *supra* note 7, at 21.

as interest in the state of residence. The question, therefore, is whether the benefits of the Parent Subsidiary Directive applying in the source state should symmetrically be granted by the residence state, thus compelling the latter to accept the characterization of the source state.

Turning to the legal context of the adoption of the Parent Subsidiary Directive, arguments can be found in favor of the symmetrical characterization by the residence state. Indeed, Article 7 of the 1990 proposal for the Parent Subsidiary Directive provided that the Directive should apply to any distribution deemed a dividend distribution in the source state. However, the final version of the Directive did not include this specific rule of interpretation. In positing an argument against symmetrical treatment by the residence state, Bungard and Jakob state that allowing such treatment would mean that "the state of residence of the recipient could not tax certain interest payments, i.e. payments classified by the source state as dividends."[171] Future guidance by the ECJ in reference to this issue is uncertain.

In the absence of a completely autonomous notion of "distribution of profits" under the Directive, the question remains whether a uniform interpretation should be applied by both Member States, and if so, which classification should prevail. Most authors agree that the source state classification should prevail in a case of asymmetry with the residence state. Yet, they acknowledge that Member States are unlikely to accept another state classification, and that, rather a uniform interpretation should be implemented. With respect to that particular issue, Vanistendael presumed the situation as follows:

> For the application of the directive it is essential that the concepts on both sides of the border are applied in the same way. This is particularly true for constructive dividends and financial instruments . . . .
>
> There are two ways of achieving this: (1) either the Member States agree on common definitions and treatment of dividends, interest and new financial instruments, which is highly unlikely, (2) or they agree on a common rule either the country of source or the country of residence as controlling in the interpretation of the qualification of the cross border payments . . . .[172]

In contrast, other authors have balanced this interpretation by concluding that the source state classification should at least prevail in cases: (1) where the residence state would have adopted a similar characterization in the opposite situation; and (2) where tax treaties compel the residence state to accept the

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[171] Bundgard, *supra* note 137, at 454. *See also* HELMINEN, *supra* note 102, at 267.

[172] Frans Vanistendael, *Looking Back: A Decade of Parent Subsidiary Directive – the Case of Belgium*, 3 EC TAX REV. 154, 162 (2001).

treatment adopted by the source state.[173] The above argument relies heavily on the necessity to reach the objective of the Parent Subsidiary Directive. To some extent, at least, there is a consensus in the tax literature that the residence state should respect the characterization of the yield from hybrid instruments in the source state in specific situations.

C. Satisfaction of the Holding Requirement by Hybrid Financial Instruments under the Directives

Addressing the question of the holding requirements set forth by the Interest and Royalties Directive and the Parent Subsidiary Directive is a difficult task. The question suggests the need to determine whether hybrid financial instruments not formally treated as equity can qualify as a "holding of . . . capital"[174] as referred to under both directives.[175] Tax literature leans toward including hybrid debt characterized as equity in the definition of holding of share capital. Specifically, Helminen concluded that

> if hybrid debt is treated as equity, hybrid debt should also be taken into account in calculating the fulfillment of the holding requirement between two companies for the purposes of the Parent-Subsidiary Directive. Parent-Subsidiary benefits should be granted even though only the constructive equity would bring the holding to the level required . . . .[176]

The provision implies that Member States should characterize a hybrid instrument fully as debt or equity and without bifurcation. Uncertainty remains however, as a different characterization may exist in the source and residence states, especially since, rather than re-characterizing the instrument itself, some countries simply reclassify the yield derived from it.

Perhaps the answer can be found in the OECD Model which, read in correlation with the directives, indicates that hybrid financial instruments may be considered capital for purposes of fulfilling the holding requirement of Article 10. The OECD Commentary interprets Article 10(2) wording for a Parent company

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[173] See HELMINEN, note 102, at 269. *See also* Eberhartinger & Six, note 7, at 23 (agreeing with Helminen, although taking the view that, as a principle at least, the parent state should not be required to accept the qualification of the source state).

[174] Council Directive 2003/49, *supra* note 134, art. 3(b) (Interest and Royalties Directive), art. 3(1)(a) (Parent Subsidiary Directive).

[175] The ECJ formally stated that it includes holding of equity capital of a subsidiary. *See* Case C-48/07, Les Vergers du Vieux Tauves SA v. Etat belge – Service public fédéral Finances SA., 2008 E.C.R. I-10627, at para. 33.

[176] HELMINEN, *supra* note 102, at 267.

that "holds directly at least 25 per cent of the capital of the company paying the dividends" as follows:

> When a loan or other contribution to the company does not, strictly speaking, come as capital under company law but, when on the basis of internal law or practice ("thin capitalization," or assimilation of a loan to share capital), the income derived in respect thereof is treated as dividend under Article 10, the value of such loan or contribution is also to be taken as "capital" within the meaning of subparagraph (a).[177]

The OECD Commentary may be used to argue in favor of the inclusion of hybrid financial instruments—although it does not directly refer to them—but still has no authority over E.U. law and consequently over the interpretation of the directives by the ECJ.

In conclusion, until the ECJ directly addresses this issue and until the absence of a definition of the term "holding in capital" in the directives is corrected, it seems that Member States enjoy some discretion in determining whether hybrid financial instrument should be included for purposes of fulfilling the holding requirement.

VII. TOWARDS THE INTRODUCTION OF A COMMON THIN CAPITALIZATION RULE IN THE CCCTB

Reaching a common definition of thin capitalization between Member States and the tremendous discrepancies between the various domestic systems have commanded the European Community institutions to think about the introduction of a common thin capitalization clause in the context of the Common Consolidated Corporate Tax Base (CCCTB).[178] Risk of tax avoidance is particularly at stake within the context of the CCCTB, making its elimination a primary objective of the adoption of the CCCTB. One of the ways contemplated by European authorities to achieve this goal is the introduction of thin capitalization rules.[179] Part (A) investigates the need for the inclusion of a thin capitalization rule within the scope of the CCCTB, before (B) considers the possible content of such clause.

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[177] OECD Model, *supra* note 154, art. 10; OECD Commentary on Article 10, *supra* note 130, para. 23.

[178] Provided that debt and equity remain treated differently for tax purposes.

[179] *See* Common Consolidated Corporate Tax Base Working Group*, Related parties in CCCTB* (CCCTB Working Paper No. 41, 2006), *available at* http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/ccctbwp041_related_parties_en.pdf.

A. Addressing the Need for a Thin Capitalization Rule in the Context of the CCCTB

The first legitimate question that should be raised is the extent of the thin capitalization phenomenon within the European Community. While the ratio of OECD countries applying thin capitalization rules has been raised by close to 75%,[180] there is little economic data to answer this question. Existing literature showed, on average, that in the E.U. an increase of a subsidiary's effective tax rate results in at least a doubling of the subsidiary's debt to total assets ratio.[181] Corroborating the European trend, available data for the United States showed in 2003 that, where foreign affiliates of U.S. corporations bear a tax rate higher by 1%, an increase of 0.4% in the debt-to-equity ratio for those affiliates could be observed.[182] It can be inferred from the above that the increase in the number of countries introducing thin capitalization rules is in line with the increase in the thin capitalization phenomenon.

Notwithstanding the aforementioned, the second question that arises is in regard to the effectiveness of thin capitalization legislation in the countries that have implemented such measures. Economic literature studying the German thin capitalization system showed that thin capitalization legislation does impact the capital structures of multinational corporations and has a constraining effect on profit shifting.[183] One issue that remains is whether, despite the purported efficiency of thin capitalization rules on profit shifting, there are adverse effects such as a decline in the level of investment in a Member State or an intensification of double non-taxation situations.

B. Extent of the Rule within the CCCTB

In addressing the possible introduction of a common thin capitalization rule within the scope of the CCCTB, working groups first had to determine

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[180] *See* Thiess Buettner et al., *The Impact of Thin-Capitalization Rules on Multinationals' Financing and Investment Decisions* 2 (Ctr. for Econ. Studies, Ifo Institute, Working Paper No. 1817, 2006), *available at* https://www.cesifo-group.de/pls/guestci/download/CESifo%20Working%20Papers%202006/CESifo%20Working%20Papers%20October%202006/cesifo1_wp1817.pdf.

[181] *See* Harry Huizinga et al., *Capital Structure and International Debt Shifting* 51-52 (Ctr. Econ. B, Working Paper No. 07-015, 2006). *See also* Alfons Weicherieder, *Fighting International Tax Avoidance: the Case of Germany*, 17 FISCAL STUDIES 37 (1996).

[182] Rosanne Altshuler & Harry Grubert, *Taxes, Repatriation Strategies and Multinational Financial Policy*, 87 J. PUB. ECON. 73, 104 (2003). S*ee also* Mihir A. Desai et al., *A Multinational Perspective on Capital Structure Choice and International Capital Markets*, 59 J. FIN. 2451 (2004) (confirming Altshuler & Grubert's findings).

[183] *See e.g.,* Buettner, *supra* note 180, 19-21; Michael Overesch & Georg Wamser, *Corporate Tax Planning and Thin-Capitalization Rules: Evidence from a Quasi Experiment*, 42 APPLIED ECON. 563 (2010).

whether a specific thin capitalization provision was necessary to reach the aim of eliminating profit shifting, or whether such an objective could be reached simply by the implementation of a general anti-abuse rule. Undeniably, from a practical standpoint, a specific provision would have the advantage of eliminating any discrepancy between Member States' thin capitalization regimes; at least between those Member States adopting the CCCTB. In addition to substantially removing legal uncertainty, a specific provision would likely be easier to administer than a general anti-abuse rule.

The difficulty in dealing with a specific rule, however, arises out of the necessary compliance of such a clause with the EC Treaty. The European Court of Justice practice, in consideration of Article 43 of the EC Treaty, has determined that thin capitalization rules are only admissible insofar as they permit "a consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement."[184] In other words, such measures should not constitute "irrefutable presumptions."[185] Furthermore, the removal of uncertainty offered by a specific rule is limited by the optional character of the CCCTB.

Consequently, the 2011 proposal did not opt for a specific clause, but rather for a general anti-abuse rule. The proposed rule does not provide for a generic interest deduction restriction, such as thin capitalization or earning stripping rules. Instead it creates an anti-abuse rule[186] on which interest deductions are restricted if paid to a low-taxed related entity which is a resident of a third state with which no exchange of information exists.[187] Specifically, under the Proposal, interest paid to an associated enterprise resident in a third country shall not be tax deductible when the statutory tax rate in the third country is less than 40% of the average statutory corporate tax rate in the E.U. Member States, or when the associated enterprise is subject to a special tax regime in the third country.

Subsequent developments demonstrate a stiffening of the Proposal's anti-abuse rule. On April 19, 2012, the European Parliament (Parliament) voted in favor of a number of amendments to the Proposal, among which was a stricter general anti-abuse clause than had been proposed by the Commission. The Parliament proposed that "artificial transactions carried out for the sole purpose of avoiding taxation shall be ignored for purposes of calculating the tax base" be

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184 Case C-524/04, Test Claimants in the Thin Cap Grp. Litig. v. Comm'rs of Inland Revenue, 2007 E.C.R. I-2107, paras. 81-82. *See also* Case C-196/04, Cadbury Schweppes Plc v. Comm'rs of Inland Revenue, 2006 E.C.R I-7995; Case C-298/05, Columbus Container Serv.s BVBA & Co. v. Finanzamt Bielefeld-Innenstadt, 2007 E.C.R. I-10451.

185 A.P. Dourado & de la Feria, *supra* note 112, at 23.

186 CCCTB Proposal, *supra* note 111, art. 81.

187 *Cf.* Council Directive 2011/16, 2011 O.J. (L 64) 1 (EU).

replaced by "artificial transactions carried out mainly for the purpose of avoiding taxation shall be ignored for purposes of calculating the tax base."[188]

Although the objective behind this change of wording was to broaden the scope of the general anti-abuse rule, the Parliament did not intend to modify Article 81 of the Proposal in a way that would lead to a stricter specific thin capitalization rule with respect to interest deductions. The further introduction of a specific thin capitalization rule by Parliament is not impossible, but is unlikely. Should it decide to head in this direction, however, it is unclear whether the Council would adopt an arm's length mechanism, a fixed debt-to-equity ratio, or a mix of both.

VIII. CONCLUSION

Divided by sovereignty, the E.U. struggles to coordinate taxation of hybrid financial instruments and thin capitalization policy. The diversity of Member States' tax systems, combined with the application of the E.U. Four Freedoms by the ECJ, has often caused damaging consequences to the taxing powers of the Member States themselves, not to mention for the taxpayers. These consequences have caused Member States to regard relinquishing sovereignty with great aversion. However, the E.U. must continue to strive for tax harmonization.

European efforts to develop tax harmonization impact companies operating in the E.U., and U.S. multinational businesses with European operations. This article aims to provide the reader with some insight into the Parent Subsidiary Directive and the Interest and Royalties Directive with regards to hybrid financial instruments and the extent to which domestic thin capitalization policy might be applicable. Although direct taxes are still the prerogative of Member States, their sovereignty over them has been to some extent restricted by E.U. Law, especially with the enactment of Interest and Royalties Directive and the Parent Subsidiary Directive. The objective is to maintain the effective functioning of the common market through the approximation of the conditions within the European Union to those of a domestic market.

This article initially establishes a framework of the challenges of tax coordination facing the E.U. by first discussing the history of its formation. Then, it compares to the U.S. experience, the E.U.'s difficult and unique task of overcoming Member States' conflicting national sovereignty interests in attempting to merge diverse governments and reconcile multiple rules. Subsequently, a discussion of how these national interests and the E.U., and more

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[188] Report on the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), EUR. PARL. DOC. (A7-0080/2012) 19, 35, 42 (2012), *available at* http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A7-2012-0080+0+DOC+PDF+V0//EN.

specifically, the ECJ's nascent handling of tax issues created a reluctance among Member States in handing over taxation authority to the E.U. that persists today. Next, the article analyzes the contemporary context surrounding the expansion of hybrid finance within the European Union. Specifically, the author focuses on the central concepts of hybrid financial instruments and thin capitalization. The author then focuses on the particular question of thin capitalization legislation as it leads to the main issues raised in the second part of this article. Next, three models of thin capitalization legislation, as well as the resulting legislation, are distinguished according to their effects: (1) re-characterization of the yield; (2) non-deductibility of the payments; and (3) re-characterization of the instrument.

Furthermore, this article attempts to analyze the Interest and Royalties Directive and the Parent Subsidiary Directive in the specific context of hybrid finance and thin capitalization, with particular emphasis on each Directive's application. In comparing the Interest and Royalties Directive and the Parent Subsidiary Directive, it was shown that the former leaves much more room for tax policy to Member States than the Parent Subsidiary Directive. Although this article only analyzes thin capitalization legislation in light of the Interest and Royalties Directive and the Parent Subsidiary Directive, an issue not dealt with here is that of its conformity to the E.U. Treaties. Prior ECJ case law has determined more often than not that thin capitalization rules are not in accordance with the non-discrimination principles embodied in E.U. Law. Nonetheless, the authority of judgments of the ECJ compels the Member States towards compliance.

Perhaps the ECJ could draw lessons from U.S. Supreme Court case law, which insists that each state tax only the portion of revenues from interstate activity which reasonably reflects the in-state component of the activity. In such instances, the ECJ would not have to impose any specific apportionment formula on the Member States, thus allowing them a margin of discretion. If a Member State attributes income to itself that is out of proportion to the business transacted within its borders or if the attribution leads to a grossly distorted result, the ECJ could strike it down.[189] Since the application of fair, but different formulas by the Member States involved still may result in multiple taxations, this approach would not abolish all double taxation. However, much like in the United States, at least the possibility of unconstrained double taxation could be avoided without the ECJ overstepping its judicial role.[190]

The proposal for a Common Consolidated Corporate Tax Base would certainly enhance European integration and limit the "creative" power of the ECJ. It would make the outcome of its judgments more predictable, and as the Commission already pointed out in 2004, "[a]t the same time, it would in many areas effectively reduce the risk that Member States' tax laws are declared to be unlawful restrictions to the Fundamental Freedoms of the Treaty by the Court of

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189 LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW 1136 (3d ed. 1990).

190 *See* Moorman Mfg. Co. v. Blair, 437 U.S. 267, 277-81 (1978).

Justice."[191] Of course, it has to be accepted that the CCCTB, if adopted on an optimal basis, would apply only—at least in a first phase—to a limited number of companies. Even if all Member States agreed to join the project, it seems that the CCCTB would remain optional, which means that national systems would continue to govern the taxation of the companies that did not opt for the CCCTB regime. Moreover, as the failure of an early attempt to introduce a common imputation system of corporation taxes in the E.U. has shown, harmonization of corporate tax systems may not be achieved.

The future of intra-E.U. hybrid finance and thin capitalization is intrinsically linked to the enactment of the Common Consolidated Corporate Tax Base (CCCTB). The CCCTB might indirectly accomplish the (partial) harmonization of thin capitalization rules. Harmonization, however, will likely be impeded by the optional character of the current CCCTB proposal and by the choice of a general anti-abuse rule over a specific thin capitalization clause. Unfortunately, the CCCTB fails to address one of the main issues that have led to the enactment of thin capitalization rules themselves: the characterization of financial instruments. Consequently, the path towards greater harmonization in this particular area remains difficult and slow. The political necessity for European Union institutions to compromise with Member States' sovereignty with respect to tax policy has been a real obstacle. The subsisting diversity of Member States' characterization and thin capitalization mechanisms, in addition to the obligation of compliance with the E.U. freedoms repeatedly asserted by the ECJ, have thus far proven too great to overcome.

Finally, it is interesting to note that on April 19, 2012, the European Parliament adopted a resolution to more effectively combat tax fraud and tax evasion. In this resolution, the Parliament notably calls the Member States to cooperate more closely and asks for the review of the Interests and Royalties Directive and of the Parent Subsidiary Directive with the objective of eliminating tax evasion produced by the use of hybrid financial instruments within the European Union.[192] One particular direction that is likely to be taken is the denial of the benefits of these directives where double taxation does not exist. The resolution was sent to the European Council and European Commission for further actions. To date, this resolution is perhaps the best way forward as far as hybrid finance and thin capitalization rules' harmonization are concerned.

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[191] Commission Non-Paper to Informal Ecofin Council, 10 and 11 September 2004: A Common Consolidated Corporate Tax Base 1 (July 7, 2004), *available at* http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/cctbwpnon_paper.pdf.

[192] For the latest development regarding this proposal, see European Commission Taxation and Customs Union, Taxation of the Financial Sector, http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm (last updated Sept. 9, 2014).