2.1.3. Structured Arrangement

Under Recommendation 10 of the Report, a structured arrangement is any arrangement where the hybrid mismatch is priced into the terms of the arrangement or the facts and circumstances of the arrangement indicate that it has been designed to produce hybrid mismatch.[20] The Report assumes that the application of this rule should be objective – it should be applied whenever the facts and circumstances would indicate to a third party that the arrangement has been designed to produce mismatch. It is very unlikely that the discussed definition will be implemented in a cohesive way in the legal systems of the relevant states.

The definition indicated the *"objective approach"* at the same time it emphasizes that the hybrid mismatch in a *"structured arrangement"* is to be assessed on the basis of facts and circumstances. As the benefit under the hybrid mismatch results from the structured arrangement made between the related parties, one should expect that the assessment of the differences constituting a *"structured arrangement"* and an arms-length driven transaction should be made by using transfer pricing valuation methodology. The Report presents several cases to illustrate the OECD approach but fails to provide one cohesive rule to be used by the legislators while implementing Recommendation 4 into national law.

2.2. Relationship of the Recommendation 4 to the remaining Recommendations of the Report

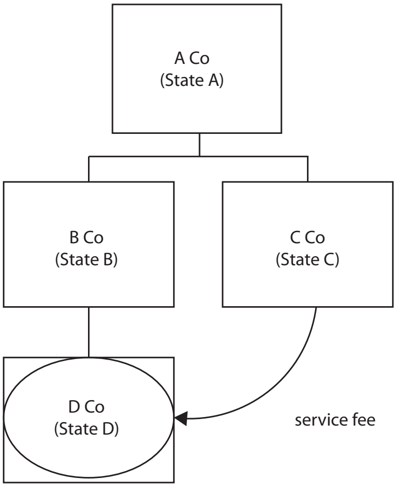
The Report assumes that the only relevant deductions are those in the payer country and that the only relevant inclusions are in the payee country. Also, the Report appears to be more focused on whether the aggregate tax base of both states is preserved and not whether it is allocated *"properly"* among them. Thus, the difference in tax rates resulting from different tax policies is not relevant to the Report.

It has to be noted that commentators[21] raised concerns about the need to coordinate CFC legislation with the work on the tax deductibility of payments under hybrid arrangements. A question on circularity arises specifically where, in the same circumstances, one jurisdiction could deny tax deductibility of payments made under hybrid arrangements and the other could apply its CFC legislation to those payments, because made by an entity falling under hybrid arrangement.

20 Report, p. 105.
21 M.A. Kane, The Role of Controlled Foreign Company Legislation in the OECD BEPS Project, Bulletin for International Taxation, June/July 2014.

2.3. Application of the Recommendation 4 – case studies

2.3.1. Payments included in the CFC income of the Parent – Example 4.3 of the Report



Facts of the case

Under this scheme, Company C (subsidiary of Company A) makes service payments to Company D (subsidiary of Company B controlled by Company A), which is a reverse hybrid under the laws of State D. All relevant entities form part of the same capital group.

Solution

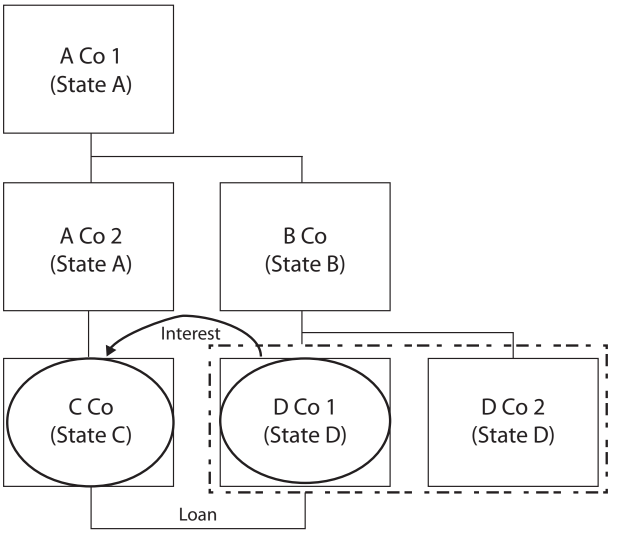
Company C makes service payments to Company D (reverse hybrid). As it stems from Recommendation 4, since State A treats income from services rendered to related parties as its attributable income subject to taxation under the local CFC rules applicable in State A there will be no restrictions as to the tax deductibility of service payments made by Company C to Company D.

Analysis

This case is a good example of how in practical terms Recommendation 4 should work. It exemplifies that there should be new legislative measures implemented in the national tax laws of all relevant countries to grant Company D access to information on the tax position of Company A to be able to demonstrate inclusion of the Company's D income in its income.

Application of Recommendation 4 in the present case will require all relevant entities to demonstrate their tax settlements to the relevant tax authorities and contracting parties to prove that the discussed payment was included in ordinary income in at least one jurisdiction. It has to be noted that this scheme would lead to hybrid mismatch under the reverse hybrid rule in case the discussed income had been taxable for Company C and at the same time the Company A had been entitled to tax credit in respect to tax paid by the Company C.[22]

2.3.2. Intra-group loans – Example 4.4 of the Report



Facts of the case

In this scheme Company A 1 and Company A 2 are residents of State A. Company A 1 has a subsidiary Company B and Company A 2 has a subsidiary Company C. Company B has established a hybrid subsidiary D 1 that is consolidated for tax purposes with its sister entity Company D 2 (not hybrid under the laws of State D). Company C makes a loan to Company D 1.

Solution

On the basis of these assumptions the question arises whether Recommendation 4 or Recommendation 6[23] of the Report will apply to deny deduction of interest under the loan.

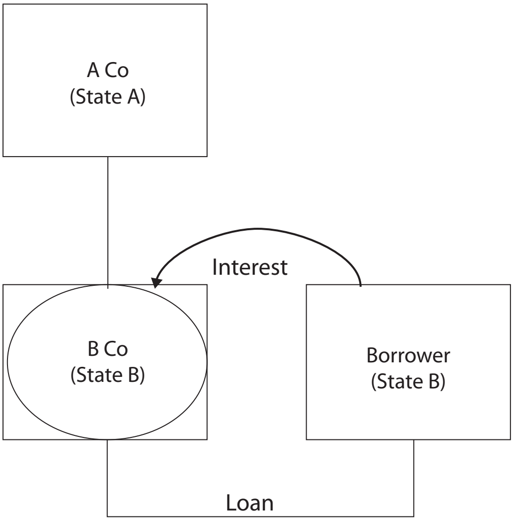
Since Company C is disregarded for tax purposes in State C, all its income is allocated to A 2 under the laws of the State C and at the same time this income is not attributable to A2 under the laws of State A.

22 Such an indirect tax credit will be available to Company A, e.g. under Maltese tax law.
23 This recommendation refers to neutralization of hybrid mismatch to the extent the payment gives rise to duplicate deduction in the parent and source jurisdictions, hereafter: “Recommendation 6”.

Analysis

The above means that the Company C is a hybrid entity and payments to that entity may result in a D/NI outcome. In this case both Country D and Country B should apply the reverse hybrid rule. The fact that Company D 1 and D 2 are consolidated for tax purposes has no relevance. Assuming that Recommendation 4 should be applied first, there will be no need to apply Recommendation 6, in other words to deny deduction for the interest payment as the discussed loan will not result in double deduction income that would fall within Recommendation 6.

2.3.3. Payment of interest to a trust



Facts of the case

Under this scheme an individual – resident in State A – is a beneficiary of a discretionary trust incorporated in State C and managed by a professional trustee (corporation) resident in State B. The trust has a participation in a hybrid corporation D Co resident in State D. D Co is considered to be a partnership by State C and as a separate taxpayer by State A. The beneficiary granted a loan to the trust and the trust granted a loan to D Co.

Solution

Assuming that Recommendation 4 will be applied, the income from interest payable to the trust by D Co should be attributed to the beneficiary despite the fact that there is no distribution of funds from the trust. The trustee should not be considered an entity controlling the trust for the purposes of attribution of income.

2. CFC rules and double taxation: How it can arise

2.1. Economic double taxation vs juridical double taxation: preliminary remarks

2.1.1. Economic and juridical double taxation

Double (or multiple) taxation is the result of the overlapping of tax claims of different countries. In the author's opinion, it represents a distortion if it leads to a tax charge that is higher compared to other domestic taxpayers in a similar situation.

The double tax treaties do not eliminate economic double taxation, but instead they constitute a system to share the tax claims among the countries involved.[13]

Juridical double taxation[14]

Juridical double taxation[15] is the double taxation within the same taxpayer of the same income characterized in the same way from a tax law perspective, in the same relevant tax year. In the case of international juridical double taxation, the different tax claims refer to tax administrations of different countries.

Generally, juridical double taxation is prevented by tax treaties.

Economic double taxation[16]

Economic double taxation is the multiple taxation within different taxpayers of an income with an identical economic nature: for example, the taxation of the net profit by the company and the dividends distributed, coming from the same net profit, by the shareholder.

Economic double taxation is not always forbidden in the domestic tax laws and normally tax treaties do not prevent it.

13 According to the OECD MC Commentary (par. 23 art. 1, par. 14 art. 7 and par. 37 art. 10) the CFC rules are not prevented by the tax treaties. However, some authors supported the opposite thesis: Renata Fontana, *European Taxation* (June 2006), pp. 263–265 and Daniel Sandler, *Tax Treaties and Controlled Foreign Companies Legislation* (The Hague: Kluwer Law International, 1998), p. 103. The author mentions the following cases: Conseil d'État, 28 June 2002, RJF 10/02 no. 1080 (*Schneider Electric*) where the French court ruled against the compatibility of the French regime with the France-Switzerland tax treaty and Bricom Holdings Ltd v IRC 1997 STC 1179 where the British court ruled in favour of the compatibility of the UK CFC regime with the UK-Netherlands tax treaty.

14 Kevin Holmes, *International Tax Policy and Double Tax Treaties* (IBFD, Amsterdam), 2007, pp. 99 et seq.

15 According to the introduction of the Commentary to the OECD MC, it can be defined *"as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Its harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the developments of economic relations between countries."*

16 Kevin Holmes, *International Tax Policy and Double Tax Treaties,* pp. 99 et seq.

Double taxation and tax treaties

Apparently, the OECD MC is focused on the prevention of the juridical double taxation and not on economic double taxation,[17] with the exception of the OECD MC Article 9, concerning the transactions between associated enterprises.[18]

2.2. How double taxation can arise by applying CFC rules

2.2.1. OECD BEPS Action 3 Final Report

According to the Action 3 Final Report,[19] there are at least three situations where double taxation may arise by applying CFC rules:

- *Situations where the attributed CFC income is also subject to foreign corporate tax;*
- *Situations where CFC rules in more than one jurisdiction apply to the same CFC income;*
- *Situations where a CFC actually distributes dividends out of income that has already been attributed to its resident shareholders under the CFC rules or a resident shareholder disposes of the shares in the CFC.*

The Final Report, in addition, refers in very general terms to *other situations*,[20, 21] by indicating, as examples:

- *Situations where there has been a transfer pricing adjustment between two jurisdictions and a CFC charge arises in a third jurisdiction.*

Situations where the attributed CFC income is also subject to foreign corporate tax

In the first situation, while the CFC has paid corporate taxes on its income, the shareholder(s) is subject to tax in its country on the same income even if not yet distributed, since that country applies CFC rules. As shown in the first section, there are different ways to characterize that income.

17 Michael Lang, "The Application of the OECD Model Tax Convention to Partnerships", a critical analysis of the Report prepared by the OECD Committee on Fiscal Affairs (Linde: Vienna, 2000), p. 29.

18 According to the Commentary OECD MC on Article 9 par. 2, par. 5: "*The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in the hands of different persons) …*".

19 OECD, *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report*, pp. 67 et seq.

20 OECD, *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report*, p. 65.

21 OECD, *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report*, p. 68 m.no. 135: "*The report recognises that double taxation can also arise in other ways, for instance through the interaction of CFC rules and transfer pricing rules.*"

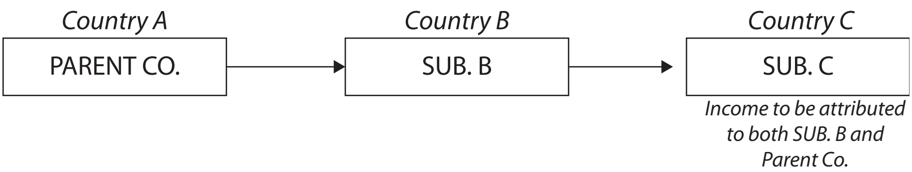
Depending on the shareholder's country's CFC rules, that income could be considered to be:

- *a deemed dividend*[22]
- *a direct attribution to the shareholder.*[23, 24]

Situations where CFC rules in more than one jurisdiction apply to the same CFC income

In order to show this situation, it is presented the example below.

Given that the recommendations set out in Action 3 do not represent a "minimum standard",[25] the interaction of different CFC rules not harmonized among them may result in double taxation situations for the taxpayer.



In this situation, there are three companies: Parent A resident in Country A and subsidiary B, resident in Country B, as well as subsidiary C resident in Country C. Both countries, A and B consider subsidiary C to be a CFC.

Assuming that both Country A and Country B have CFC rules, then both may apply their CFC legislation, with the risk of generating a double or multiple taxation on the same income. For instance, Country A and B attribute a different CFC income and it could be questionable for Country A to give a tax credit to Company A for the taxes paid on the CFC income in Country B by the Subsidiary B, since the income is determined differently. The situation becomes even more complicated in the case of real distribution: it would be very difficult to trace the exact amount of income already attributed and hence already taxed: for Country A it could be hard to grant a credit for taxes paid in B on the CFC income in such a situation.

This situation will get even more complicated if the number of countries involved increases.

22 Bruno Gouthiere, "Overview of the French CFC legislation", European Taxation (February 2008), pp. 53 et seq.

23 Alexander Rust, "National Report Germany" in: Michael Lang/Hans-Jörgen Aigner/Ulrich Scheuerle/Markus Stefaner, "CFC legislation, Tax Treaties and EC law" (The Hague: Kluwer Law International, 2004), pp. 269–270.

24 Alexander Rust, "CFC Legislation and EC Law", Intertax (2008), pp. 493–494.

25 FN. 4.

3.2.2. The existence of an obstacle to the fundamental freedoms

As acknowledged by the Final Report itself, Member States implementing its recommendations may be in violation of the fundamental freedoms mainly due to the definition of the personal scope of the Interest Limitation Regime.[52]

As already mentioned, the Final Report categorizes the entities to whom the Interest Limitation Regime should apply in three kinds: entities which are part of a multinational group; entities which are part of a domestic group and stand-alone entities which are not part of a group. Then, the Final Report recommends, as a minimum, applying the Interest Limitation Regime to the entities which are part of a multinational group.[53] Indeed, it is only in an inbound or outbound scenario that a group may artificially place a higher level of debt on entities established in high-tax jurisdictions, thus shifting the taxable income to jurisdictions providing more favourable tax regimes.

One may wonder whether, given the current status of ECJ case law, Member States may apply the Interest Limitation Regime only in cross-border scenarios or whether they are *de facto* obliged to treat cross-border and domestic situations alike in order not to infringe one of the fundamental freedoms.[54]

Essentially, from the perspective of a Member State, the application of the Interest Limitation Regime to multinational group only would introduce a difference of treatment of entities resident in their territory depending on the place of residence of the entity which controls them or the place of residence of the entity controlled by them.

Such a difference of treatment is similar to that typically introduced by thin cap regimes.[55] In the case law relevant to the latter,[56] the ECJ addressed the issue from the perspective of subsidiaries resident in a Member State controlled by companies resident in another Member State. In those instances, the ECJ held that thin cap regimes make it *"less attractive for companies established in other Member*

52 See Final Report, paras. 49–51.

53 Final Report, para. 44.

54 Indeed, after the judgments in the *Lankhorst-Hohorst* and *Thin Cap* cases, many Member States decided to extend the scope of their thin cap legislation so as to also cover domestic situations in order to avoid potential EU law issues. This has been labelled by the European Commission an undesirable event. See *Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries* (COM[2007] 785 final), p. 7.

55 The scholars who so far discussed the compatibility of the measures recommended by the Final Report with ECJ case law pointed to the ECJ case law on thin cap legislations as main source of reference. See Sjoerd Douma, *British Tax Review* (2015), p. 373; Paula Régil, "BEPS Actions 2, 3 and 4 and the Fundamental Freedoms: Is There a Way Out?", *European Taxation* (2016), p. 239; Christiana HJI Panayi, *Bulletin for International Taxation* (2016), p. 101.

56 ECJ, Judgment 12 December 2002, C-324/00, *Lankhorst-Hohorst*; ECJ, Judgment 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*; ECJ, Judgment 17 January 2008, C-105/07, *NV Lammers & Van Cleeff*.

States to exercise freedom of establishment and they may, in consequence, refrain from acquiring, creating or maintaining a subsidiary in the Member State which adopts that measure."[57]

A similar analysis applies for the Interest Limitation Regime recommended by Action 4 when its application is triggered by the circumstance that the resident company is controlled by a company resident in another Member State. Furthermore, the existence of an obstacle to the freedom of establishment should be confirmed in the symmetrical case in which the Interest Limitation Regime is triggered by the circumstance that the company resident in a Member State controls a company resident in another Member State. Indeed, under established case law, *"even though, according to their wording, the Treaty provisions on freedom of establishment are aimed at ensuring that foreign nationals are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation"*.[58]

A similar conclusion could be drawn in respect of the potential breach of the free movement of capital. As already pointed out in section 3.2.1.2. above, the ECJ holds that, in the absence of a Treaty definition of "movements of capital", reference should be made to the list enshrined in Annex I to the Council Directive 88/361/EEC of 24 June 1988. Such a list includes, among the movements of capital, the *"participation in new or existing undertaking with a view to establishing or maintaining lasting economic links"*. Therefore, it may be concluded that legislation, such as the Interest Limitation Regime, which, as above elaborated in respect of the freedom of establishment, is able to hinder cross-border acquisition of shares, constitutes an obstacle to the free movement of capital as well.

3.2.3. The grounds for justification

Under the Rule of Reason developed by the ECJ, a measure which is found *prima facie* restrictive of a fundamental freedoms is nonetheless acceptable if: *(i)* it is justified by an overriding reason of public interest; *(ii)* its application is actually able to protect such public interest and *(iii)* it is proportionate as it does not go beyond what is necessary to attain the objective pursued.

Over the years, in its direct tax case law, the ECJ seems to have accepted the following grounds for justification:[59] the need for an effective fiscal supervision; the

57 ECJ, Judgment 13 March 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation*, para. 61.

58 ECJ, Judgment 29 November 2011, C-371/10, *National Grid Indus BV*, para. 35. See also, among other cases, ECJ, Judgment 16 July 1998, C-264/96 *ICI*, para. 21; ECJ, Judgment 6 December 2007, C-298/05 *Columbus Container Services*, para. 33; ECJ, Judgment 23 October 2008, C-157/07 *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt*, para. 29; ECJ, Judgment 15 April 2010, C-96/08 *CIBA*, para. 18.

59 Ben Terra/Peter Wattel, *European Tax Law*, p. 60.

need to protect fiscal coherence; the need to protect a balanced allocation of taxing powers and the need to prevent the abuse of rights.

Given that the Interest Limitation Regime essentially seeks to avoid erosion of the domestic tax base, then, of the above listed grounds, one may wonder whether a discriminatory Interest Limitation Regime which applies only to entities which are part of multinational group may be justified by the need to prevent the abuse of rights or by the need to protect a balanced allocation of taxing rights.

Over the years the approach adopted by the ECJ has evolved: it came to combine the two above grounds of justification.

3.2.3.1. The need to prevent the abuse of rights as a stand-alone ground for justification

In the first judgments in which the ECJ accepted the need to prevent the abuse of rights, the Court adopted a strict approach in terms of proportionality and limited the possibility for Member States to rely on such grounds only in cases in which the restrictive measure at stake was specifically designed to target "wholly artificial" arrangements.

Indeed, in the *Lankhorst-Hohorst* case, concerning the then German thin cap legislation which applied only in cross-border situations, the Court rejected the anti-abuse justification, reasoning that *"As regards more specifically the justification based on the risk of tax evasion, it is important to note that the legislation at issue here does not have the specific purpose of preventing wholly artificial arrangements, designed to circumvent German tax legislation, from attracting a tax benefit, but applies generally to any situation in which the parent company has its seat, for whatever reason, outside the Federal Republic of Germany"*.[60] A similar approach has been confirmed also in the *Cadbury Schweppes* case where the ECJ held that *"in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory."*[61]

As argued by scholars, for the purposes of the application of the justification based on the need to prevent the abuse of rights, such an approach demanded that Member States establish the existence of an abuse "on a case by case basis". Indeed, the Court seemed to consider altogether disproportionate measures addressed to an entire category of cross-border transactions which entails a mere risk of abuse.[62]

60 ECJ, Judgment 12 December 2002, C-324/00, *Lankhorst-Hohorst*, para. 37.
61 ECJ, Judgment 12 September 2006, C-196/04, *Cadbury Schweppes*, para. 37.
62 Ben Terra/Peter Wattel, *European Tax Law*, p. 915. See also Otto Marres, "Interest Deduction Limitations: When To Apply Articles 9 and 24(4) of the OECD Model", *European Taxation* (2016), pp. 10–11.