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Practical Issues of the Anti-Hybrid Rule in the Parent Subsidiary Directive

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In a recent post, Professor Werner Haslehner raised an interesting discussion on the new wording of Article 4.1 (a) of the Parent-Subsidiary Directive ("PSD"), which obliges the Member State of the parent company to tax the dividends received to the extent that the corresponding payment are deductible from the corporate income tax paid by the subsidiary. The declared purpose of this amendment is to tackle deduction and non-inclusion schemes derived from cross-border tax arbitrage with hybrid financial instruments, in situations where the remuneration is classified as dividend at the level of the parent company and as interest at the level of the subsidiary. Within the EU, many countries, such as Denmark,[1. Section 2 B of the Corporate Tax Act, as amended by Law No. 344, of 18 April 2007.] Germany,[2. Section 20, Abs. 1 of the Income Tax Act (*Einkommensteuergesetz – EstG*). The matching principle for dividends in § 8b(1) of the Corporate Income Tax Act (*Körperschaftsteuergesetz – KStG*).] Austria[3. Section 10 (7) of the Austrian Corporate Income Tax Act.] and the United Kingdom,[4. Sections 931B(c) and 931D(c) of the Corporate Taxation Act (CTA).] have already implemented anti-hybrid rules even before the amendment of the PSD, for purposes of denying the participation exemption where the correspondent payment was deducted at the level of the subsidiary company in the source state.

Professor Werner Haslehner discussed extensively whether the EU has competence to impose an obligation to tax on Member States. This post will follow up on the discussion about the anti-hybrid rule introduced in the PSD, highlighting some practical issues that may arise in its application to concrete cases.

Firstly, as already mentioned by Professor Werner Haslehner in his post, anti-hybrid rules based on the PSD are not entirely successful in tackling hybrid mismatches arrangements, because the obligation to tax is only applicable within its material and territorial scope, which comprise profits distributed by an EU subsidiary to its EU parent company. This implies that, outside the scope of the PSD, companies may still structure transactions with hybrid financial instruments between an EU and a non-EU company, in order benefit from exemptions granted by domestic law or tax treaties, mainly by Member States that desire to attract foreign investors.

Furthermore, in order to circumvent the application of anti-hybrid rules, tax-planning structures may be adopted to avoid either the substantial participation of 10% or other requirements for the application of the PSD, especially when domestic law or tax treaties grant any kind of relief to portfolio dividends. To this end, dividend washing or dividend stripping transactions, which entail a temporary transfer of the title to the shares just before the distribution of dividends, may now be used in the opposite direction to get around domestic anti-hybrid rules. This may open room for the use of investment funds, collective investment vehicles, usufruct agreements, total return swap, among other tax planning strategies, for the purpose of falling outside the scope of the Parent-Subsidiary Directive and of the anti-hybrid rule.

Secondly, anti-hybrid rules based on the PSD may affect legal transactions that were not originally intended to be covered. As already mentioned, Article 4.1 (a) of the PSD states that the Member State of the parent company must “refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary”. Thus, this legal provision may be rendered applicable where the country of the subsidiary denies, based on its national thin capitalization rules, the deduction of a payment characterized as interest under its domestic law. In this situation, there are two possible outcomes, without any reasonable justification for the unequal tax treatment. On the one hand, if the country of the parent company characterizes the payment as interest, the amount may be taxed based on its domestic law, under the Interest and Royalty Directive (“IRD”). On the other hand, if the country of the parent company characterizes the payment as profit distribution, within the context of the PSD, the corresponding amount must not be taxed to the extent that the corresponding payment was not deducted at the level of the subsidiary. Therefore, the European Commission did not properly address this type of mismatch, stemming from the classification of the payment for the purposes of applying both directives. If it were acknowledged that the neutralization of hybrid mismatches arrangements and their effects is a goal to be pursued by the European Union, it would be consistent to adopt a more comprehensive approach, instead of just focusing on particular types of tax planning strategies.

Thirdly, the European Commission did not address the interaction between the PSD and the IRD. For instance, Article 4(1) of the IRD allows the source Member State to exclude certain payments from its material scope, especially hybrid financial instruments that fall between equity and debt. In this case, the interest expense is deductible from the taxable profit of the subsidiary, but the source state keeps the right to impose the withholding income tax on the remittance. The application of this provision simultaneously with the new rule introduced in the PSD may end up in juridical double taxation, due to the levy of the withholding income tax on the payment made by the subsidiary and the taxation of the amount received at the level of the parent company. Even if the parent company grants a tax credit on the withholding income tax charged in the country of the subsidiary, the sum of the withholding income tax and the underlying tax paid by subsidiary may exceed the amount of corporate income tax due in the country of the parent company. In this scenario, the tax credit granted to the parent company may be limited, because Member States that rely on the credit method do not carry their capital export neutrality principle to the point of refunding the foreign tax credit. It follows that the concomitant application of both rules may cause an overkill effect.

Fourthly, the amendment of the PSD does not provide a proper solution for the cases in which Member States rely on the indirect credit method to avoid double taxation. A full tax credit of the corporate income tax paid by the subsidiary, along with the deduction of the amount distributed to the parent company, would also lead to double non-taxation. The wording of Article 4(1)(b) of the PSD does not clarify whether the deduction of the remuneration derived from the hybrid instrument reduces the amount of the tax credit. In order to avoid increasing disparities between the exemption and the credit method, which are not fully equivalent remedies, the European Commission should have explicitly addressed the issue.

Fifthly, the anti-hybrid rule introduced in the PSD linked the tax treatment applicable to the profit distribution to the deduction or not of the corresponding amount at the level of the first-tier subsidiary. Thus, it disregards the fact that considering only the first-tier subsidiary may often lead to economic double taxation. In a vertical line of investment, the profits generated by the second-tier subsidiary and distributed to the first-tier subsidiary as dividends may be taxed again at the level of the parent company, in case the payment made by the first-tier subsidiary has been characterized as deductible interest expense under the domestic law of that state. This result seems incompatible not only with the proportionality test, but also in conflict with the objective and purpose of the PSD.

Sixthly, anti-hybrid rules based on the PSD do not cover by the notional interest deduction provided for by the domestic law of certain countries, especially Belgium. Strictly speaking, Article 4.1 (a) of the PSD does not cover the notional interest deduction, because the dividend distributed is not deductible at the level of the subsidiary. However, from an economic perspective, it is possible to argue that the notional interest deduction ensures a similar effect, as it allows the subsidiary to deduct the amount corresponding to its risk capital from the tax base of the corporate income tax. Since it does not produce a mismatch in tax outcomes in the sense contemplated by the PSD, taxpayers may exploit notional interest deductions, and Member States may use it as an alternative to attract foreign investors.

Finally, anti-hybrid rules patterned on the PSD may divert attention from the real problem, which is the relative tax burden at various relevant margins, regardless of the number of different times that the same income is taxed under the tax system of different countries. It is possible to claim that what really matters in a cross-border context is the final tax burden charged at a certain margin, irrespective of the number of taxes that are effectively charged, since any taxpayer will probably prefer to be taxed twice at a 10% rate each time than once at a 35% rate. Thus, the ideal solution would be to focus on the overall effective tax burden at the margin, rather than on the number of times that the cross-border income is taxed.

In this regard, anti-hybrid rules may also go beyond what is necessary to attain the objective of avoiding double non-taxation. Considering the existence of differences in statutory tax rates among EU Member States, anti-hybrid rules may create overkill or underkill effects that negatively affect cross-border transactions. For example, the overkill effect may occur where the payment is deducted at the level of the subsidiary at a 20% rate, whereas the corresponding amount is taxed at the level of the parent company at a 35% rate. In contrast, the underkill effect may occur where the payment is deducted at the level of the subsidiary at a 35% rate, whereas the corresponding amount is taxed at the level of the parent company at a 20% rate.

Based on the above, it is possible to conclude that the anti-hybrid rule introduced in the PSD may give rise to several issues within the EU, which shows that cross-border tax arbitrage with hybrid financial instruments will continue to pose a significant challenge for the international tax regime, due to the fact that inherent differences in the tax rules of several jurisdictions create unique opportunities for taxpayers to engage in tax planning strategies.

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This entry was posted on Monday, September 7th, 2015 at 5:36 pm and is filed under EU/EEA, Hybrids
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