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Hybrid Financial Instruments, Double Non-taxation and Linking Rules: (only some) issues stemming from the apparent 'solution'

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May linking rules related to hybrid financial instruments be incompatible with the EU Fundamental freedoms? And with Article 24 (4) OECD MC? What about treaty override?

It is no secret that hybrid financial instruments (HFIs) serve actual business and legal purposes by allowing investors and issuers to better meet their economic and legal needs from many different perspectives (e.g. corporate policy, corporate finance, corporate law, financial accounting law, regulatory law and even tax law). Nevertheless, it is also well-known that HFIs might lead to conflicts of qualification both domestically and across borders and to either double taxation or double non-taxation (DNT) in the latter cross-border setting from a tax law perspective.

Although these HFIs are widespread ordinary financial instruments that may relate –if so– to tax planning, and DNT stemming from them is just a mere consequence of parallel exercises of sovereignty by different states, the OECD and the EU have developed very complex rules (i.e. linking rules, see here, here, here and here) in an attempt to tackle some forms of DNT across borders. While battling DNT in general terms might be seen commendable and necessary from a policy perspective –if so, especially whenever abuse is at stake, it must found consistent policy and legal grounds. And such grounds are quite questionable when it comes to tackle DNT stemming from HFIs.

This is so because the outcome of DNT stemming from HFIs does not relate to base erosion, profit shifting nor abuse and not every kind of DNT stemming from financial instruments across borders is in the cross hairs (e.g. institutional hybrid financial instruments such as notional interest deductions or, perhaps, Brazilial *Juros sobre ó Capital Próprio*). In addition to the foregoing, the apparent *solution* in the form of linking rules –as limitation on tax planning clauses– may not only be unrelated to the *mantra* of *taxing income wherever is generated and value is created* considered in the very OECD and EU initiatives – whatever it may mean, but it may certainly be incompatible with pre-existing tax treaty rules because of e.g. discrimination and treaty override, and with EU primary law in terms of Fundamental freedoms.

From *taxing income wherever it is generated and value is created* to a taxation no-matter-where approach

The apparent solution proposed by the OECD and the EU would avoid particular outcomes of

DNT through the intended consequential application of a set of rules. In broad strokes now, linking rules related to hybrid financial instruments would include a (1) *prior rule* – e.g. Article 4.1 (a) of the PSD (2014/86) or Recommendation 2.1. BEPS Project Action 2 –, and (2) *proper linking rules* – i.e. the so-called primary rule and secondary rule.

These rules would in principle assure one layer of taxation either at the level of the payer or the payee, and, consequently, avoid particular outcomes of DNT by unilaterally and automatically modifying the domestic tax treatment of an instrument (or better said, payment derived therefrom) taking into consideration the tax treatment provided (or expected to be provided) to the same payment in the counterparty jurisdiction.

In the context of the EU, linking rules relate to the amended exemption method laid down in Article 4.1(a) of the PSD (2014/86), which denies the application of the exemption method at the level of the payee to distributed profits that are deductible at source – and obliges to tax them – (i.e. *prior rule*), and to the proper linking rules laid down in Article 9.2 ATAD (2016/1164) after its amendment by ATAD 2 (2017/972) (hereinafter, Article 9.2 ATAD). Notwithstanding the relevant issues regarding the insufficient definition of core elements of the rules and the many technical issues stemming from their design, the primary rule would imply, in short, the denial of the deductibility of a payment from the taxable base of the payer because of the non-taxation of such payment at the level of the non-resident payee. The secondary rule would imply the inclusion of the payment in the taxable base of the payee in those instances where the payment would lead to the outcome of double non-taxation across borders because of its deductibility at the level of the payer.

With respect to the general mechanics of linking rules, whenever there is a mismatch in tax outcomes (i.e. double non-taxation) across borders, the residence jurisdiction would apply any domestic *prior rule* denying the applicable dividend exemption to specific payments taking into consideration their deductibility at source. Nevertheless, if the potential (not actual) outcome of double non-taxation persists because of the non-application (or the absence) of the prior rule at residence, the primary rule would come into play by the source country denying the deductibility of payments. Lastly, if the mismatch in tax outcomes still persists because the primary rule has not been applied by the source country, the residence country would apply the secondary rule.

In short, the prior rule favours taxation at residence, the primary rule favours taxation at source, and the secondary rule leads to taxation at residence. It is easy to notice that these rules do not relate to the mantra of *taxing income wherever it is generated and value is created*, but they nevertheless relate to a taxation no-matter-where approach leading to one layer of taxation, at least. Regardless of the exact meaning –if any– of *taxing income wherever it is generated and value is created*, how linking rules operate has nothing to do with it. These rules limit tax planning by taxing income no matter where. And it is relevant to recall once again that DNT stemming from HFIs relates to the proper and due application of the law in every jurisdiction involved where avoidance (abuse) and the undefined (and misleading) base erosion and profit shifting are not present whatsoever. This is about revenue –no matter where.

Legal issues? A bit about the incompatibility with tax treaties and EU Primary Law

Although this no-matter-where approach *might* relate to feasible and reasonable policy choices, it does lead to actual legal issues in terms of the incompatibility of linking rules with pre-existing tax treaty rules and EU primary law.

- *At Treaty Level – discrimination and treaty override*

When it comes to tax treaties, there are very strong reasons to conclude that the denial of the deductibility of payments at source because of the non-taxation of payments at residence (i.e. primary rule) is **discriminatory** and incompatible with tax treaties following the wording of Article 24 (4) OECD MC, at least as considered in BEPS Project Action 2. Such a primary rule actually provides a more burdensome treatment to cross-border payments than the one provided to payments made *under the same conditions* in a domestic setting by denying the deductibility of interest because of a feature inextricably related to the residence of the payee (i.e. the potential *mismatch* in tax outcomes stemming from a conflict of qualification across borders). In this regard, it is relevant to keep in mind that (1) unless due to dysfunctionalities or policy reasons, there is no possible conflict of qualification of instruments or payments within the same jurisdiction in the sense of linking rules, and (2) interest payments relate regular expenses incurred for potential income generation and their tax deductibility exclusively relates to the determination of the tax base at the level of the payer according to the ability-to-pay principle and net basis taxation. In short, the primary rule implies that cross-border interest payments comparable to domestic ones are treated differently leading to discrimination proscribed by Article 24 (4) OECD MC.

With respect to the *prior rule* and the secondary rule, these two domestic and unilateral rules may lead to **treaty override** whenever the relevant tax treaty lays down an unconditional exemption for dividends at the level of the payee (e.g. Article 23 (3) Brazil-Spain DTC, see here). This unconditional character of the method relates to the inexistence of any condition upon its application such as the level of taxation at source or the absence of any switch-over rule or subject-to-tax rule at treaty level.

- *At EU level – subsidiarity and Fundamental freedoms*

At EU level, concerns not only relate to the Fundamental freedoms since the ATAD may not be in line with the **Principle of Subsidiarity** laid down in Article 5 of the TEU, at least in terms of linking rules and HFI. It would be possible to conclude that linking rules do not allow to better achieve the objectives of the very ATAD in comparison with what Member States could have achieved by their own –if so. In a nutshell, this is because (i) ATAD (neither PSD) does not focus on the underlying cause leading to double non-taxation across borders, i.e. the different qualification of financial instruments (and payments); (ii) ATAD may lead to additional mismatches and loopholes without removing all existing ones because of its own complex design and mechanics; and (iii) hybrid financial instruments do not relate to any kind of base erosion, profit shifting nor avoidance. Moreover, it is relevant to highlight in this regard that the preparatory documents of the ATAD did not provide any kind of qualitative or quantitative assessment on the benefits of linking rules in the EU context (see here, for instance, the critics raised by Malta).

On another level, and notwithstanding that the *prior prior* rule (PSD) and the secondary rule (ATAD) face similar challenges in terms of their incompatibility with the Fundamental freedoms as the primary rule does, this post deals only with the latter. In this regard, the primary rule laid down in Article 9.2 ATAD is incompatible with the **Fundamental freedoms,** particularly the freedom of establishment and the free movement of capitals.

The primary rule is meant to deny the deductibility of interest payments because of their tax treatment at the level of the recipient under a conflict of qualification scenario. A conflict of qualification that whenever related to hybrid financing inherently and exclusively affects cross-border situations. The primary rule treats differently comparable domestic and cross-border situations in terms of determining the tax base of the payer because of an inherent feature attached to the seat (residence) of the payee (i.e. the application of its own tax system leading to non-taxation and, eventually, double non-taxation across borders). Therefore, the primary rule leads to a different treatment of similar (or identical) payments because of the seat of the recipient. It is the different taxation at the level of the payer and not the taxation at the level of the recipient which turns the primary rule into a discriminatory measure against the fundamental freedoms, unless justification grounds uphold such a rule in the light of the case-law of the CJEU.

In terms of the different justification grounds that might be considered in this context, it is important to recall once again that DNT stemming from HFIs relate to parallel exercises of sovereignty where avoidance (or abuse) is not present. This outcome of DNT does not relate to "wholly [not even partially] 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" [*Cadbury Schweppes* (C-196/04), para. 55]. Quite the contrary, it relates to the due and proper application of the law in every single jurisdiction involved leading to non-taxation domestically and, eventually, double non-taxation across borders. The primary rule does not fulfil the current standard of abuse upheld by the CJEU – at least in its current form.

Nor does it in terms of the balanced allocation of taxing rights. If it is possible to consider that this justification resembles the motto of *taxing income wherever it is generated and value is created* and that it would allow Member States to exercise their taxing powers with respect to activities carried out in their own territories, linking rules do not serve such purposes. On the one hand, linking rules are based on a taxation no-matter-where approach as already considered (*see supra)*. On the other hand, taxing powers are perfectly allocated and Member States duly and correctly exercise them, yet double non-taxation is the final outcome. The deduction of interest payments does not affect the taxing rights of any jurisdiction whatsoever but, instead, relates to an exercise of sovereignty in terms of the determination of the tax base of the payer according to the ability-to-pay principle and net basis taxation. Therefore, the mechanics of linking rules and their ulterior motives do not get along well with the balanced allocation of taxing rights as a justification ground.

With respect to the coherence of *the* tax system, this justification ground has traditionally been devoted to *a* single jurisdiction in relation to the *same tax* and the *same taxpayer*, existing a link between the *tax advantage* concerned and *a particular levy*. In this regard, DNT stemming from HFIs relate to *two taxpayers* subjected to *two different taxes* in *two different jurisdictions*. In this regard, it is relevant to recall once again that interests are expenses incurred for the development of the business activity and their deducibility does not relate to a *tax advantage*, but to the correct determination of the tax base of the payer. The expenses that interest payments represent are related to profit (income) generation and that profit will eventually (and normally) be taxed, when accrued, in the hands of the very payer of interests. Therefore, the already mentioned *direct link* and the coherence of the tax system is completely granted, but within the same taxpayer. In other words, the coherence of the tax system with respect to interest deductibility would be granted by the taxation of forthcoming earnings stemming – to a certain extent – from that cost on financing (i.e. interest payments). The coherence of the tax system is neither a suitable justification ground for the restriction of the Fundamental freedoms that the primary rule represents.

Linking rules may respond to a reasonable policy concern – if so – that may turn in actual legal issues. Having all these brief comments in mind, it would be reasonable to reassess whether the apparent cure in the form of linking rules might not be worse than the apparent disease in the form of double non-taxation, and whether it would be reasonable to reconsider their current form and design.

This post briefly shows some of the issues and conclusions considered in the recent publication on Series on International Taxation (Kluwer Law International): Martínez Laguna, F.D. (2019), Hybrid Financial Instruments, Double Non-taxation and Linking Rules, Kluwer Law International (Series on International Taxation 73). Please check the publication for further detail and references.

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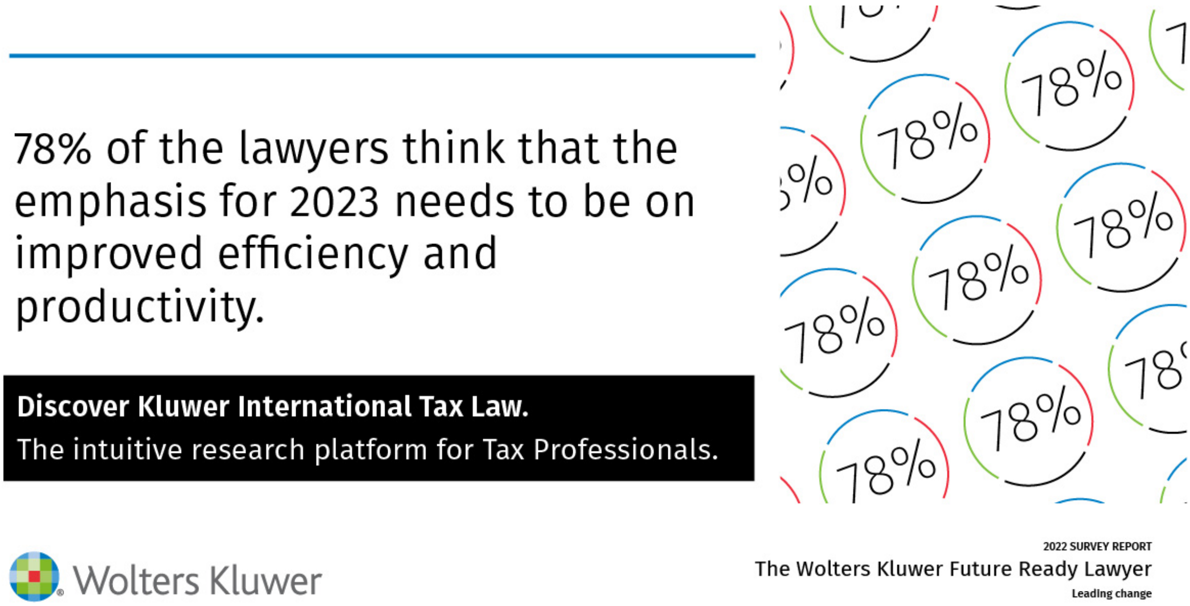

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