Chapter 9
National Tax Policy, the Directives and Hybrid Finance

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9.1 Introduction

The right of legislation in the area of taxation is part of the sovereign right of each Member State, providing that State with autonomy of decision-making as regards its tax policy measures. This autonomy, however, is restricted by EU law in three ways:

1. Member States are bound by the Four Freedoms,[1] and in the determination of those freedoms by the jurisdiction of the ECJ.[2]
2. Member States are subject to secondary EU Law in the form of regulations, directives and decisions.[3]
3. Member States are bound by the code of conduct for business taxation.[4]

The focus of this article rests on the effect of secondary EU Law, in the form of directives, on the autonomy of national tax policy in the Member States in the area of direct taxation. Up to now, directives have been a major tool used by the Council in bringing the national law of the Member States into line with the requirements of a common domestic market within the European Community.[5] Most of these directives contain very detailed provisions in order to achieve their intended goals.[6] Directives in the area of direct taxation, although few in number, are rather detailed and, thus, effectively constrain the Member States' autonomy in implementing tax policy. Nevertheless, apart from a wilful decision not to implement a directive, either in full or in part, some leeway remains for tax policy in the Member States in the course of the implementation of the directives.

It is the aim of this chapter to show that there is indeed room for tax policy in the Member States, taking the treatment of hybrid cross-border finance between associated companies as an example. We look at this in the context of the Parent-Subsidiary Directive (90/435/ECC) and the Interest and Royalties Directive (2003/49/EC). These directives have been chosen, because they are interrelated, very detailed and have been implemented by the majority of the Member States.[7]

From the standpoint of the taxation of hybrid financial instruments, these are the most relevant directives, as hybrid financial instruments combine elements of

debt and equity, by definition.[8] This means that the Member States' classification of the relevant instrument as equity or as debt, respectively, for domestic tax purposes, defines the yield as a dividend or as an interest payment. This, in turn, may or may not fall within the scope of application of the Parent-Subsidiary Directive or of the Interest and Royalties Directive. Since these classification issues have immediate consequences for the total amount of income taxes levied by the Member States concerned, we regard them as a good example in showing what can still be done by the Member States despite the EU directives. We will, therefore, concentrate on the options remaining for policy makers in the Member States in the following analysis, and examine the application of the terms dividend, interest and holding in capital on hybrid instruments in the course of the implementation of the aforementioned directives.

The chapter is organized in the following way. Section 9.2 focuses on hybrid finance and the research question. Section 9.3 addresses the implementation of the directives into national law. In Sect. 9.4 the aim and scope of the Parent-subsidiary directive is discussed, whereas in Sect. 9.5 the focus is on the aim and scope of the Interest and royalty directive. Section 9.6 analyzes the role of hybrid finance in these two directives. Finally, concluding remarks are provided in Sect. 9.7.

9.2 Hybrid Finance - The Problem

The compartmentalisation of company finance into equity and debt does not truly capture the enormous diversity of financial securities available. A wide variety of financial instruments incorporate elements of both equity and liability.[9] Usually, these financial instruments cannot be clearly attributed to either equity or debt and are, therefore, referred to as "hybrid"-instruments or mezzanine finance. The spectrum of hybrid instruments ranges from corporate shares with features typical of loans (such as certain preference shares) to loans with features usually associated with equity investments (such as participation in profit and loss). Such equity-type loans would include *inter alia* jouissance rights, silent partnerships, participation bonds, convertible bonds, warrant bonds, profit participation loans and preference shares.

The classification of such instruments as equity or debt may or may not be of particular interest from an investor's point of view, as hybrid instruments may be issued for a variety of non-tax reasons.[10] From a fiscal point of view, however, the classification as equity or debt is crucial for two reasons. First of all, the issuer can treat interest on the latter as tax-deductible in most cases, and secondly, for the investor the classification determines whether the payments received from the respective instrument is treated as a dividend or as interest.[11]

This classification for tax purposes is the source of important opportunities and risks in the area of international tax management, especially in international groups, where hybrid instruments can be used efficiently as flexible, tailor-made forms of finance. As long as no anti-avoidance rules, such as "Subject-To-Tax" Clauses are applicable, the qualification of the hybrid instrument as debt in the source state and as equity in the state of residence of the parent company could