THE EU PASSIVE INCOME TAX DIRECTIVES

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THE EU PASSIVE INCOME TAX DIRECTIVES

A Commentary on the Parent-Subsidiary and Interest-Royalty Directives

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Elgar Commentaries in Tax Law

Edward Elgar PUBLISHING

Cheltenham, UK • Northampton, MA, USA

Published by

Edward Elgar Publishing Limited

The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

Authorised representative in the EU for GPSR queries only: Easy Access System Europe – Mustamäe tee 50, 10621 Tallinn, Estonia, gpsr.requests@easproject.com

A catalogue record for this book is available from the British Library

Library of Congress Control Number:

This book is available electronically in the **Elgar**online
Law subject collection
https://doi.org/10.4337/9781035334292

ISBN 978 1 0353 3428 5 (cased)
ISBN 978 1 0353 3429 2 (eBook)
ISBN 978 1 0353 8136 4 (ePub)

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1

THE PARENT-SUBSIDIARY DIRECTIVE: INTRODUCTION AND PREAMBLE

Niels Bammens and Filip Debelva

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 115 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Parliament,[1]

Having regard to the opinion of the European Economic and Social Committee,[2]

Acting in accordance with a special legislative procedure,

Whereas:

(1) **Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States**[3] **has been substantially amended several times.**[4] **Since further amendments are to be made, it should be recast in the interests of clarity.**

(2) **In the light of the judgment of the Court of Justice of 6 May 2008 in Case C-133/06,**[5] **it is considered necessary to redraft the wording of the second**

1 Opinion delivered on 4 May 2011.
2 OJ C 107, 6.4.2011, p. 73.
3 OJ L 225, 20.8.1990, p. 6.
4 See Annex II, Part A.
5 [2008] ECR I-03189.

subparagraph of Article 4(3) of Directive 90/435/EEC, for the purpose of clarifying that the rules referred to therein are adopted by the Council acting in accordance with the procedure provided for in the Treaty. It is furthermore appropriate to update the Annexes to that Directive.

(3) **The objective of this Directive is to exempt dividends and other profit distributions paid by subsidiary companies to their parent companies from withholding taxes and to eliminate double taxation of such income at the level of the parent company.**

(4) **The grouping together of companies of different Member States may be necessary in order to create within the Union conditions analogous to those of an internal market and in order thus to ensure the effective functioning of such an internal market. Such operations should not to be hampered by restrictions, disadvantages or distortions arising in particular from the tax provisions of the Member States. It is therefore necessary, with respect to such grouping together of companies of different Member States, to provide for tax rules which are neutral from the point of view of competition, in order to allow enterprises to adapt to the requirements of the internal market, to increase their productivity and to improve their competitive strength at the international level.**

(5) **Such grouping together may result in the formation of groups of parent companies and subsidiaries.**

(6) **Before the entry into force of Directive 90/435/EEC, the tax provisions governing the relations between parent companies and subsidiaries of different Member States varied appreciably from one Member State to another and were generally less advantageous than those applicable to parent companies and subsidiaries of the same Member State. Cooperation between companies of different Member States was thereby disadvantaged in comparison with cooperation between companies of the same Member State. It was necessary to eliminate that disadvantage by the introduction of a common system in order to facilitate the grouping together of companies at Union level.**

(7) **Where a parent company by virtue of its association with its subsidiary receives distributed profits, the Member State of the parent company must either refrain from taxing such profits, or tax such profits while authorising the parent company to deduct from the amount of tax due that fraction of the corporation tax paid by the subsidiary which relates to those profits.**

(8) **It is furthermore necessary, in order to ensure fiscal neutrality, that the profits which a subsidiary distributes to its parent company be exempt from withholding tax.**

(9) **The payment of profit distributions to, and their receipt by, a permanent establishment of a parent company should give rise to the same treatment as that applying between a subsidiary and its parent. This should include the situation where a parent company and its subsidiary are in the same Member State and the permanent establishment is in another Member State. On the other hand, it appears that situations where the permanent establishment and the subsidiary are situated in the same Member State can, without**

prejudice to the application of the Treaty principles, be dealt with on the basis of national legislation by the Member State concerned.

(10) **In relation to the treatment of permanent establishments Member States may need to determine the conditions and legal instruments in order to protect the national tax revenue and fend off circumvention of national laws, in accordance with the Treaty principles and taking into account internationally accepted tax rules.**

(11) **When corporate groups are organised in chains of companies and profits are distributed through the chain of subsidiaries to the parent company, double taxation should be eliminated either by exemption or tax credit. In the case of tax credit the parent company should be able to deduct any tax paid by any of the subsidiaries in the chain provided that the requirements set out in this Directive are met.**

(12) **This Directive should be without prejudice to the obligations of the Member States relating to the time limits for transposition into national law of the Directives set out in Part B of Annex II,**

HAS ADOPTED THIS DIRECTIVE:

COMMENTARY

A. HISTORICAL BACKGROUND

Directive 2011/96/EU,[6] commonly known as the Parent-Subsidiary Directive, was adopted on 30 November 2011. The present directive is a recast directive that consolidates and codifies the earlier Directive 90/435/EEC,[7] including **1.001**

6 Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 345/8.

7 Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L225/6.

its amending acts, Directive 2003/123/EC[8] and Directive 2006/98/EC.[9] The original Parent-Subsidiary Directive, adopted in 1990, had established the framework for eliminating double taxation on dividends paid between associated companies of different Member States. However, due to several amendments over time, a consolidated text became necessary for legal clarity and coherence, as indicated in the first recital of the directive.[10] The new directive officially repealed Directive 90/435/EEC, but preserved the transposition deadlines applicable to the amending acts, as specified in Annex II of the directive (Article 9 PSD).[11]

1.002 The original Parent-Subsidiary Directive was the culmination of a lengthy legislative process that began more than two decades earlier. The first Commission proposal, submitted on 16 January 1969,[12] reflected the early (and steep) ambitions of the European Economic Community to eliminate tax barriers impeding the free movement of capital and establishment of companies within the common market. However, due to political sensitivities surrounding corporate taxation and concerns about the potential revenue impact for Member States, the proposal was stalled for years and was ultimately never adopted in its original form.

1.003 The 1969 proposal and the final 1990 directive shared the same core objective: to eliminate double taxation of profit distributions between associated companies in different Member States. Nevertheless, there were several differences between the two texts, indicating that the original directive was more ambitious in several aspects:

- The 1969 proposal had a more ambitious scope, seeking to establish broad common rules for taxation within corporate groups by providing an option for consolidation of profits. By contrast, the 1990 directive took a more limited and pragmatic approach, focusing narrowly on dividend distributions between qualifying parent and subsidiary companies.
- The 1969 proposal relied on a more general definition of companies with a 20% holding requirement, while the 1990 directive provided a precise and exhaustive

8 Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ 2003 L7/4

9 Directive 2006/98/EC of 20 November 2006 adapting certain Directives in the field of taxation, by reason of the accession of Bulgaria and Romania, OJ L 363.

10 Recital 1 PSD.

11 In addition, references to the repealed directive are now deemed to refer to Directive 2011/96/EU and must be interpreted in accordance with the correlation table provided in Annex III.

12 Proposal for a Council Directive on the Common System of Taxation Applicable to Parent Companies and their Subsidiaries of Different Member States, COM(69) 6 final, OJ C 39, 22 March 1969.

list of eligible legal forms (included in Annex to the Directive) and imposed a higher minimum ownership threshold (initially 25%, later reduced to 10%) for the parent-subsidiary relationship to qualify.

- The 1969 proposal leaned more strongly toward exemption methods to eliminate double taxation. The 1990 directive, by contrast, offered flexibility to Member States by allowing either the exemption method or the credit method for the taxation of received dividends.

The original Parent-Subsidiary Directive was amended twice. The first (and most important) changes were introduced by Directive 2003/123/EC, adopted on 22 December 2003. This Directive introduced several substantive amendments to the original Parent-Subsidiary Directive with the aim of broadening its scope,[13] improving its effectiveness, and preparing it for application in an enlarged European Union. Notable changes included gradually lowering the minimum shareholding threshold required for a parent company to benefit from the Directive. Initially set at 25%, this threshold was lowered in stages: to 20% as of 1 January 2005, 15% as of 1 January 2007, and finally to 10% from 1 January 2009. **1.004**

Furthermore, the directive also expanded the list of qualifying company forms included in Annex I, Part A. This revision updated the Annex to reflect the legal company forms recognized in the Member States and, crucially, incorporated company types from the accession countries that were due to join the EU in 2004. In addition, the Directive's scope was enlarged to include the two European company forms, the European Company (SE) and the European Cooperative Society (SCE). Lastly, the scope of profit distributions was expanded to also include distributions involving permanent establishments, a multi-tier tax credit was introduced, and a provision dealing with hybrid entities was added. In 2006, Directive 2006/98/EC adapted the directive due to the accession of Bulgaria and Romania.[14] **1.005**

Directive 2011/96/EU itself was also amended on a number of occasions. A first amendment took place with Council Directive 2013/13/EU of 13 May 2013.[15] This Directive was adopted to adapt the PSD's provisions in light of the accession of the Republic of Croatia to the European Union, which took **1.006**

13 Recital 7 Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ 2003 L7/4.

14 Directive 2006/98/EC of 20 November 2006 adapting certain Directives in the field of taxation, by reason of the accession of Bulgaria and Romania, OJ L 363.

15 Council Directive 2013/13/EU of 13 May 2013 adapting certain directives in the field of taxation, by reason of the accession of the Republic of Croatia OJ L 141, 28.5.2013.

place on 1 July 2013. The most recent amendments mostly aim to address evolving tax planning strategies and to improve the directive's effectiveness in eliminating double taxation without facilitating double non-taxation or abuse. Directive 2014/86/EU,[16] adopted on 8 July 2014, amended Article 4 of Directive 2011/96/EU to address hybrid mismatches arising from differences in the tax treatment of profit distributions. It clarified that the exemption of distributed profits at the level of the parent company shall not apply if the distribution is tax deductible at the level of the subsidiary.

1.007 Subsequently, Directive 2015/121/EU,[17] adopted on 27 January 2015, introduced a general anti-abuse rule (GAAR) into Article 1 of the directive. This provision requires Member States to deny the benefits of the Directive in cases where arrangements are not genuine and have been put in place with the main purpose or one of the main purposes of obtaining a tax advantage contrary to the objective of the directive. The GAAR reflects a broader shift in EU tax policy toward combating aggressive tax planning and aligns the directive with the anti-abuse principles enshrined in other EU instruments and OECD recommendations under the BEPS Action Plans.

B. GENERAL OVERVIEW

1.008 According to the third recital in the preamble of Directive 2011/96/EU, the Directive's objective is "to exempt dividends and other profit distributions paid by subsidiary companies to their parent companies from withholding taxes and to eliminate double taxation of such income at the level of the parent company." In essence, the Directive seeks to abolish two principal forms of double taxation that may arise in a cross-border context when profits are distributed between subsidiaries and parent companies situated in different EU Member States: economic double taxation and juridical double taxation:

- *Economic double taxation* occurs when the same income is taxed in the hands of *two different taxpayers*, typically at the level of the subsidiary (as corporate profits) and again at the level of the parent company (upon distribution of dividends).
- *Juridical double taxation*, by contrast, arises when the *same taxpayer* is taxed in two different jurisdictions on the same income—most often through a *withholding tax*

16 Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States OJ L 219, 25.7.2014.

17 Council Directive (EU) 2015/121 of 27 January 2015 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States OJ L 21, 28.1.2015.

levied in the source state (subsidiary) and corporate income tax in the residence state (parent).

Directive 2011/96/EU addresses both forms by (i) requiring Member States to exempt dividend distributions from withholding tax (Article 5 PSD), and (ii) obliging them to eliminate taxation of received dividends at the level of the parent company, either through exemption or credit mechanisms (Article 4 PSD).[18] The result is a framework intended to ensure tax neutrality within corporate groups operating across EU borders, thereby facilitating the proper functioning of the internal market. **1.009**

18 In addition, Article 6 PSD states that the Member State of a parent company may not charge withholding tax on the profits which such a company receives from a subsidiary.

2

ARTICLE 1(1): MATERIAL SCOPE OF APPLICATION

Edoardo Traversa and Fabrizio Pascucci

Each Member State shall apply this Directive:

(a) **to distributions of profits received by companies of that Member State which come from their subsidiaries of other Member States;**
(b) **to distributions of profits by companies of that Member State to companies of other Member States of which they are subsidiaries;**
(c) **to distributions of profits received by permanent establishments situated in that Member State of companies of other Member States which come from their subsidiaries of a Member State other than that where the permanent establishment is situated;**
(d) **to distributions of profits by companies of that Member State to permanent establishments situated in another Member State of companies of the same Member State of which they are subsidiaries.**

COMMENTARY

A. BASIC OPERATION OF ARTICLE 1(1)

The purpose of Council Directive 2011/96/EU[1] (hereinafter, "Parent-Subsidiary Directive" or "PSD") is to promote the grouping of companies established in different Member States[2] by introducing an exemption from corporate income taxes on inbound dividends in the Member State where the recipient is a tax resident[3] and, at the same time, an exemption from withholding taxes on outbound dividends in the Member State of the distributing company.[4] In broader terms, the function of the Parent-Subsidiary Directive is to eliminate (juridical and economic) double taxation on intra-EU dividend flows,[5] thereby removing potential disparities in the tax treatment of EU-groups when compared to wholly domestic groups. The Parent-Subsidiary Directive therefore facilitates EU integration, promoting the single market and strengthening the freedom of establishment[6] and the free movement of capital.[7] **2.001**

To this end, Article 1(1) PSD sets forth its material scope of application, namely the fundamental conditions that must be met in order for the exemptions to become available to EU corporate taxpayers. **2.002**

From a formal point of view, Article 1(1) PSD consists of two pairs of statements: **2.003**

- The first pair of statements (i.e. Article 1(1)(a) and (b) PSD) concerns profit distributions[8] between companies of different Member States. More specifically, it

1 Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States OJ L 345/8, which replaced Council Directive 90/435/EEC of 23 July 1990. Council Directive 2011/96/EU has been amended twice, that is, by Council Directive 2014/86/EU of 8 July 2014 OJ L 219/40 and by Council Directive (EU) 2015/121 of 27 January 2015 OJ L 21/1.

2 Recitals 4-5 PSD.

3 Article 4(1) PSD.

4 Article 5 PSD.

5 Recital 3 PSD.

6 Article 49 TFEU (former Article 43 TEC).

7 Article 63 TFEU (former Article 56 TEC).

8 The Parent-Subsidiary Directive does not contain a definition of "profit distribution". As noted by Helminen, there is a general understanding according to which "profit distribution" is somewhat broader than "dividend", thereby encompassing, for example, disguised distributions, such as hidden distributions. See M. Helminen, *EU Tax Law – Direct Taxation – 2023* (IBFD 2023), Chapter 3.1, 8, https://doi.org/10.59403/3be7nw4 (accessed 8 April 2024).

deals with (i) profit distributions received by (parent) companies established in a Member State from subsidiaries established in another Member State; and (ii) profit distributions made by subsidiaries established in a Member State to (parent) companies established in another Member State.

- The second pair of statements (i.e. Article 1(1)(c) and (d) PSD) concerns profit distributions between companies and permanent establishments. Essentially, it covers (i) profit distributions received by a permanent establishment located in a Member State of a company established in another Member State from subsidiaries established in a Member State other than the Member State where the permanent establishment is located; and (ii) profit distributions made by subsidiaries established in a Member State to permanent establishments located in another Member State.

2.004 Insofar as companies are concerned, the approach is rather straightforward, as the Parent-Subsidiary Directive covers exclusively those situations where the profit distribution occurs between legal entities established in two Member States (subject to complying with the additional requirements that will be analysed in the next sections).

2.005 In the scenarios involving permanent establishments, however, the application of the Parent-Subsidiary Directive becomes more controversial, given that further implications may come into play.

2.006 It is unequivocal, on the one hand, that the exemption applies in all cases where the permanent establishment is located in a Member State other than the Member State of the company making the distribution (and the permanent establishment belongs to a company established in another Member State). However, the applicability of the Parent-Subsidiary Directive in those cases where the company making the distribution and the permanent establishment are located in the same Member State is not so obvious, given that the Member State may consider the transaction as an internal distribution and, as such not covered by the Parent-Subsidiary Directive.[9]

2.007 In any case, permanent establishments belonging to companies of Member States should be granted the same (tax) treatment in the Member State where they are located as the treatment applicable to the resident companies of that

9 On this point, see O. Marres, 'Chapter 6. The Parent-Subsidiary Directive' in P.J. Wattel, O. Marres and H. Vermeulen (eds), *European Tax Law – Vol. 1* (7th edn, Kluwer Law International 2018), 127-128. See also M. Helminen, *EU Tax Law – Direct Taxation – 2023* (IBFD 2023), Chapter 3.1, 4, https://doi.org/10.59403/3be7nw4 (accessed 8 April 2024).

Member State. This is essentially the decision of the European Court of Justice (hereinafter, "CJEU") in *Compagnie de Saint Gobain*.[10]

Another situation that may seem ambiguous is that involving a permanent establishment located outside the EU which belongs to a company located in a Member State. According to some authors,[11] a distribution made between a subsidiary and a parent company located in two Member States could be covered by the Parent-Subsidiary Directive even if such distribution is connected with a non-EU permanent establishment of an EU parent company. However, in such cases, in accordance with the definition included in Article 1(2) PSD, a permanent establishment "means a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on". Therefore, this seems to imply that the Parent-Subsidiary Directive applies only to the extent that both the head office (i.e. the parent company) and its permanent establishment are located in a Member State (in such case, the parent company may be also established in the same Member State as the subsidiary, the distribution being connected with a permanent establishment located in another Member State[12]). **2.008**

Likewise, in the case of permanent establishments established in a Member State of a non-EU company, the Parent-Subsidiary Directive should exclude the applicability of the exemption from corporate taxes on the dividends received by the permanent establishment, and accordingly the exemption from withholding taxes on dividends paid by the EU subsidiary. However, in this case, a discrimination may arise between permanent establishments established in the EU which belong to non-EU companies and subsidiaries of non-EU companies located in the same state, as the permanent establishment of a non-EU company would be treated less favourably than a subsidiary of a non-EU company (i.e. the latter being able to benefit from the exemption regime). **2.009**

B. "DISTRIBUTION OF PROFITS"

The concept of profit distribution is not defined in the Parent-Subsidiary Directive. Nevertheless, in consideration of the objectives of the Parent-Subsidiary Directive, it is widely accepted that the term "profit distribution" includes all those situations in which the economic results of the subsidiary **2.010**

10 Case C-307/97 Compagnie de Saint-Gobain [1999] ECLI:EU:C:1999:438.

11 M. Helminen, *EU Tax Law – Direct Taxation – 2023* (IBFD 2023), Chapter 3.1, 4, https://doi.org/10.59403/3be7nw4 (accessed 8 April 2024).

12 Recital 9 PSD.

are transferred, in whole or in part, to the parent company by virtue of the association of the subsidiary with the latter. Furthermore, it is also agreed that the definition is somehow broader than the concept of dividend *stricto sensu*. Hence, the Parent-Subsidiary Directive should also cover hidden distributions, payments recharacterised as dividends according to anti-abuse provisions (e.g. thin-cap rules) and other atypical forms involving returns on shareholdings.

2.011 However, the distribution of profits shall be necessarily associated with an actual payment, thereby implying that notional payments, such as notional interest calculated on an interest-free loan, cannot be considered as a distribution of profits in the sense of the Parent-Subsidiary Directive. This issue has been addressed by the CJEU in *Viva Telecom Bulgaria*.[13]

2.012 The Parent-Subsidiary Directive does not seek to uniform the qualification of financial instruments across the EU, as equity or debt instruments, nor the qualification of the payment made under these instruments. Therefore, it is possible that Member States adopt a different characterisation of the financial instrument according to their domestic tax rules. In such cases, the Parent-Subsidiary Directive remains available to the extent that the transaction is regarded as a profit distribution in accordance with the domestic legislation of the concerned Member States. However, following the amendment introduced in 2014,[14] the Parent-Subsidiary Directive includes an anti-hybrid rule aimed at avoiding situations of (economic) double non-taxation across Member States. In the case of hybrid financial instruments (i.e. financial instruments qualified as debt in one Member State and as equity in another Member State), the exemption at the level of the parent company shall be available only to the extent that the payment has not been deducted when determining the taxable result of the subsidiary.

C. "COMPANY OF A MEMBER STATE"

2.013 The Parent-Subsidiary Directive applies to companies established in one of the Member States that receive (distribute) profits from (to) a company located in another Member State. This can be easily deduced from the first two statements contained in Article 1(1)(a) and (b) PSD. However, pursuant to Article

13 Case C-257/20 Viva Telecom Bulgaria [2022] ECLI:EU:C:2022:125.

14 Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States OJ L 219/40.

2(a) PSD, three additional conditions are required for the definition of "company of a Member State" to be met.

For the sake of clarity, note that the three additional requirements laid down in Article 2(a)(i-iii) PSD must be met jointly, and at the level of both entities involved in the transaction, given that the definition of "company of a Member State" shall be respected both at the level of the distributing entity and at the level of the recipient entity. **2.014**

Because of its importance for the PSD's material scope of application as defined in Article 1, the definition of Article 2(a) will be briefly addressed below. A more general discussion of that definition can be found in Chapter 4. **2.015**

1. Article 2(a)(i) PSD: corporate forms

Article 2(a)(i) PSD requires that the companies take one of the predetermined forms set out in Annex I, Part A PSD. **2.016**

This requirement must be met at the level of both companies. Consequently, if one of the companies does not meet this condition, neither the exemption from corporate taxes in the Member State of the recipient nor the exemption from withholding taxes in the Member State of the distributing entity would be granted under the Parent-Subsidiary Directive. **2.017**

Annex I, Part A PSD includes those corporate forms of the Member States that are usually reserved to public limited companies and limited liability companies, and those additional corporate forms which are normally reserved to companies carrying on commercial activities under the domestic legislation of the Member State. **2.018**

Some Member States, such as Belgium, Italy, France and Luxembourg, expressly provide for an exhaustive list of the corporate forms which are covered by the Parent-Subsidiary Directive. Other states, such as Portugal and Lithuania, instead provide that the benefits of the Parent-Subsidiary Directive are available to all companies that are incorporated under the domestic (corporate) legislation of the concerned Member State. In the first case, therefore, the list of entities covered by the Parent-Subsidiary Directive should be considered as a *numerus clausus*, thereby implying that other entities – despite possibly being fully liable to tax (and subject to tax) in that Member State – will not be able to benefit from the beneficial tax regimes granted by the Parent-Subsidiary Directive. **2.019**

2.020 To this end, it is worth recalling the *Gaz de France* decision,[15] in which the CJEU was expressly asked to interpret the term "company of a Member State" under the Parent-Subsidiary Directive.[16] More specifically, in *Gaz de France*, two interpretative questions were referred to the CJEU:

- Whether Article 2(a) PSD, read in conjunction with point (f) of Annex I, Part A PSD should be interpreted as meaning that a French company in the form of a "*société par actions simplifiée*" may be regarded as a "company of a Member State" within the meaning of the PSD *ratione tempore* applicable (i.e. even before it was amended by the Council Directive 2003/123).
- Whether Article 2(a) PSD, read in conjunction with point (f) of Annex I, Part A infringed the freedom of establishment or the free movement of capital by providing an exemption from withholding taxes only for the three listed French legal forms, but not for other companies taking the corporate form of *société par actions simplifiée*.

2.021 After discussing the preliminary issues, the CJEU provided an in-depth examination of the legislative techniques used in Annex I, Part A PSD, emphasising that the lack of a "residual clause" in point (f) (i.e. a clause that would also include corporate taxpayers which are not expressly listed) inhibits access to the benefits of the PSD for all those companies whose corporate form is not included in the annex,[17] despite them being liable to tax (and subject to taxes without the possibility of being exempted) in that Member State. The approach adopted by the CJEU was therefore to privilege the principle of legal certainty over flexibility of forms. This is even more relevant in the case at hand, given that point (f) of Annex I, Part A PSD would be extended shortly afterwards (in 2003) to include additional corporate forms established in France, among which the *société par actions simplifiée*.

2.022 This principle is also confirmed in *GVC Services*,[18] where the CJEU clarified (at para. 35) that there is no possibility of extending the scope of the Parent-Subsidiary Directive by analogy to other forms of companies other than those listed in Annex I, Part A PSD, given that the substantive scope of the EU Directive is defined by an exhaustive list of companies.

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15 Case C-247/08 Gaz de France [2009] ECLI:EU:C:2009:600.

16 For a comprehensive analysis of the CJEU decision in *Gaz de France*, see F. Boulogne and W. Geursen, 'Gaz de France: Dividends to Companies Not Listed in the Parent-Subsidiary Directive Are Not Exempt' (2010) European Taxation, issue 4, 129.

17 Case C-247/08 Gaz de France [2009] ECLI:EU:C:2009:600, para 38.

18 Case C-458/18 GVC Services [2020] ECLI:EU:C:2020:266.

Concerning the second question – that is, whether the *numerus clausus* in point (f) infringes the freedom of establishment (or the free movement of capital, in some cases) – in *Gaz de France* the CJEU clarified (at paras. 59-60) that, to the extent that a Member State does not treat the distribution of profits to companies of another Member State not covered by the PSD less favourably than the profits which are distributed to "comparable" companies established in that Member State, no infringement occurs, provided that the selection of measures and procedures to eliminate or mitigate international double taxation – among which the choice concerning the corporate forms to be included in Annex I, Part A PSD – shall be left to the Member States. **2.023**

The foregoing thus implies that being excluded from the exhaustive list necessarily entails the inapplicability of the exemptions granted under the PSD insofar as the domestic situation and the intra-EU situation are objectively different, given that the EU fundamental freedoms may come into play to extend *de facto* the material scope of the PSD. **2.024**

This is precisely the case of *Aberdeen Property*,[19] where a Finnish company paid dividends to a Luxembourg parent entity which was not only excluded from the list of corporate forms contained in Annex I, Part A PSD, but was also exempt from corporate taxation in Luxembourg (the recipient company being a "*société d'investissement à capital variable*", essentially an investment fund which benefitted from a subjective exemption in Luxembourg). **2.025**

More precisely, in *Aberdeen Property*, the CJEU was asked to rule whether the application of withholding taxes in Finland on outbound dividends restricted the freedom of establishment and, therefore, whether a discrimination existed between purely internal and intra-EU dividends distributed to this type of investment funds. Against this background, the CJEU explained that the application of withholding taxes indeed constituted a restriction to the freedom of establishment despite the Luxembourg fund not being included in the list of Annex I, Part A PSD, considering that if the profits had been distributed to a Finnish parent company neither corporate taxes, nor withholding taxes would have been levied on such distribution. **2.026**

The interesting aspect of *Aberdeen Property* is that the CJEU held that a restriction existed even in the absence of a Finnish corporate form equivalent to the Luxembourg investment fund, on the assumption that any differences existing between such a type of foreign fund and a Finnish fund (or in any case **2.027**

19 Case C-303/07 Aberdeen Property [2009] ECLI:EU:C:2009:377.

a Finnish parent company) were not such as to constitute objectively different situations.[20] The decision thus implies that, although it is not possible to disregard the exhaustive nature of the list, there may still be situations where entities that are not included in the list *de facto* benefit from the exemptions granted under the PSD.

2.028 In addition to the typical corporate forms of the Member States, the list expressly includes European Companies (referred to as "*Societas Europaea*") and European Cooperative Companies (referred to as "*Societas Cooperativa Europaea*"), incorporated under Council Regulation (EC) No. 2157/2001 of 8 October 2001 and Council Regulation (EC) No. 1435/2003 of 22 July 2003, respectively.

2.029 Evidently, the corporate forms indicated in Annex I, Part A PSD represent all those entities which are typically fully liable to tax in that Member State. Indeed, it would not make any sense to include in the exhaustive list entities which would then necessarily be excluded from the definition of "company of a Member State" on the basis of the subsequent criterion included in Article 2(a)(ii) PSD (because, for example, the entity is not regarded as a tax resident in that Member State). In effect, this is the reason why the list in Annex I, Part A PSD does not include entities that are generally considered by Member States as fiscally transparent entities, such as partnerships and equivalent forms.

2. Article 2(a)(ii) PSD: tax residence

2.030 Having one of the corporate forms listed in Annex I, Part A PSD is a necessary but not a sufficient condition for a profit distribution to benefit from the exemptions. It is also required that the companies involved in the transaction are tax resident in one of the Member States, and that the tax residence in the European Union also applies for purposes of the tax treaties concluded by the Member States in question. Indeed, the second part of Article 2(a)(ii) PSD requires that under the terms of a double taxation agreement concluded by that Member State with a non-EU State, the company is not considered to be resident for tax purposes outside the European Union.

2.031 As is the case for the requirement relating to the legal form (see above), the assessment should be carried out both at the level of the company receiving the distribution and the company making the distribution. This is clear from the

20 On this point, see paras. 37-56 of the CJEU decision in *Aberdeen Property*.

text of Article 1(a) and (b) PSD, which requires that the parent company and its subsidiaries are both "companies of a Member State".

In essence, therefore, Article 2(a)(ii) PSD introduces a double condition. The first condition operates at the level of the internal tax rules of the Member State concerned (given that the tax residence of companies is normally regulated at a domestic level), while the second requires an analysis at the treaty level. In particular, it is possible that a company is considered as a tax resident in a Member State according to its domestic rules, but that it qualifies as a resident of a non-EU State according to the provisions of the tax treaty between that non-EU State and the Member State in question.[21] For example, this may occur in the case of a dual-resident company, that is, a company that is at the same time tax resident in a Member State and in a non-EU State according to the domestic laws of both States. Such a company may ultimately be considered as tax resident only in that latter State for purposes of the tax treaty by virtue of the tie-breaker clause included in that treaty.[22] **2.032**

Note, for the sake of completeness, that this rule refers only to those tax agreements concluded between a Member State and a non-EU State. The reason is that, if it concerns a tax treaty between two Member States, the determination of the entity's tax residence under the tax treaty would not trigger any prejudices to the objective of the Parent-Subsidiary Directive as the company would still end up being considered as tax resident of a Member State. **2.033**

On the basis of the above, it can be said that the rule contained in Article 2(a)(ii) PSD is, to a certain extent, an anti-avoidance rule, as taxpayers may take advantage of dual-resident companies to exploit the exemptions granted under the PSD for profit distributions. For the same reason, that rule does not apply also in those cases where the dual-resident company is established in a Member State which does not have a tax treaty with the relevant non-EU State, provided that in such a scenario the dual-resident company would still be liable to tax in that Member State. **2.034**

21 Which normally prevails over internal tax law.

22 For example, this could be the case if a company is established in a Member State which privileges the incorporation criterion, but is also considered as being tax resident in a non-EU State where its place of effective management is located. If the tax treaty between those states would give preference to the place of effective management, the company would qualify as a resident of the non-EU State for tax treaty purposes.

2.035 The condition required in Article 2(a)(ii) PSD is substantially analogous to the requirement included in Article 4 of the OECD Model Convention,[23] given that tax treaty benefits are available only to those entities which are regarded as being tax resident in one or both the Contracting States.[24] In order for a company to access the bilateral tax treaty, it is indeed necessary that under the laws of that Contracting State, it is liable to tax therein by reason of its domicile, residence, place of management or any other criterion of a similar nature.[25] That is, that the company is subject to full tax liability (as opposed to limited tax liability) in the Contracting State in which it is established in application of the internal tax rules of that concerned jurisdiction.

2.036 The same approach is essentially adopted in Article 2(a)(ii) PSD since, despite the differences in the wording of the two provisions, this rule also provides that tax residence is established pursuant to the application of the internal rules of the Member States concerned. Put differently, just like the OECD Model Convention, the Parent-Subsidiary Directive does not contain an autonomous definition of residence for tax purposes and relies instead on domestic tax rules.

2.037 Also, the last part of Article 4 of the OECD Model Convention is somewhat similar to the last sentence of Article 2(a)(ii) PSD. While that part of Article 4 of the OECD Model Convention serves different functions (some of which are subject to debate in the literature), it excludes from the application of a tax treaty's benefits those entities which, by reason of a tax treaty with a third country, are regarded as being tax resident in that latter country.[26] [27]

2.038 What might be different, however, is the approach to be taken in the interpretation of the expression "liable to tax" contained in Article 4 of the OECD Model Convention. This is particularly the case because the reference to tax residence in both provisions could lead to heterogeneous results, although they pursue similar objectives (i.e. essentially, to grant a more favourable treatment compared to the relevant domestic tax rules).

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23 OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (OECD Publishing, 2017), available at https://doi.org/10.1787/mtc_cond-2017-en.

24 Article 1(1) of the OECD Model Convention.

25 More specifically, Article 4(1) of the OECD Model Convention reads as follows: "For the purposes of this Convention, the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as a recognised pension fund of that State. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein".

26 OECD Commentary on Article 4, para. 8.2.

27 Quite obviously, the last part of Article 4 of the OECD Model Convention does not contain any references to non-EU States, as that distinction would not make any sense in this different context.

The condition laid down in Article 2(a)(ii) PSD refers exclusively to the fact that the company shall be resident for tax purposes in one of the Member States on the basis of the domestic tax rules of that Member State. That is, the provision simply requires that the company be abstractly subject to full tax liability in that Member State without attaching any relevance to the actual taxability of the taxpayer. Namely, the requirement is met even in those situations where the company claiming access to the benefits of the Parent-Subsidiary Directive is considered as a tax-exempt entity in its Member State. This is unequivocal, given the presence of the further condition contained in the subsequent Article 2(a)(iii) PSD, i.e. the additional condition requiring that the company be subject to one of the taxes contained in Annex I, Part B PSD without the possibility of being exempted (or of an option). In contrast, the OECD Model Convention does not contain any reference to the subject-to-tax requirement (neither in the residence article, nor in any other treaty provision). **2.039**

For this reason, certain scholars, and to a certain extent the OECD itself, argue that the definition of "liable to tax" included in the first sentence of Article 4 of the OECD Model Convention is such as to exclude those companies which, for example, are not subject to an actual tax burden in the Contracting State due to a (subjective) exemption.[28] In this sense, therefore, one could argue that the tax residence requirement should be understood differently in the two provisions. **2.040**

On the other hand, however, one might be led to believe that the lack of any indication regarding the subject-to-tax requirement in Article 4 of the OECD Model Convention, and in general in all its provisions, actually indicates that tax treaty benefits (as opposed to those stemming from the Parent-Subsidiary Directive) are in no way conditioned upon the verification of an actual tax burden in the hands of the claiming taxpayer. **2.041**

The practical consequence would therefore be that the exemption from withholding tax on outbound dividends may not be available to the claimant under Article 2 PSD, but it would be still available under a bilateral treaty modelled after the OECD Model Convention which has been concluded by the two Member States involved in the intra-EU transaction. **2.042**

28 On this interpretative question, see among others J. Wheeler, 'The Missing Keystone of Income Tax Treaties' (2011) World Tax Journal, issue 2, 252.

3. Article 2(a)(iii) PSD: the subject-to-tax requirement

2.043 The last condition for an entity to be considered as a company of a Member State is contained in Article 2(a)(iii) PSD. That provision requires the company to be subject to one of the taxes listed in Annex I, Part B PSD without the possibility of an option or of being exempt, or to any other tax which may be substituted for any of those taxes. The list of taxes contained in Annex I, Part B PSD does not raise particular concerns, as it is evidently an exhaustive list outside of which the requirement can never be met, except in those cases where the company is subject to a tax that unequivocally replaces one of the taxes listed in Annex I, Part B PSD (for example, this could be the situation where a domestic corporate tax is abolished for another that expressly replaces the former).

2.044 The requirement contained in Article 2(a)(iii) PSD is *prima facie* similar to the list included in Article 2(3) of the OECD Model Convention, as the latter provision lists those (income and capital) taxes to which the bilateral convention applies. However, upon closer inspection, the function of these two provisions is rather different, considering that, while the taxes listed in Article 2(a)(iii) PSD determine whether the Parent-Subsidiary Directive applies, Article 2(3) of the OECD Model Convention indicates those taxes which are covered by the tax treaty (i.e. those taxes to which the limitations provided for by the bilateral agreement apply).[29]

2.045 In addition, the lists contained in these two provisions have a substantially different nature, as the list of taxes included in Annex I, Part B PSD is a *numerus clausus*, whereas the list of Article 2(3) of the OECD Model Convention is an illustrative list whose function is solely to illustrate the preceding paragraphs of Article 2 (this is also clarified in paragraph 6 of the OECD Commentary on Article 2).[30]

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29 M. Tenore, 'Taxes Covered: The OECD Model (2010) versus EU Directives', (2012) Bulletin for International Taxation, issue 6, 6. Specifically, the author reckons that, differently from Article 2 of the OECD Model Convention, Article 2 PSD does not list the taxes covered, but instead indicates those taxes that should be taken into account when assessing whether a company meets the definition of a "company of a Member State" (i.e. this definition has nothing to do with the taxes which are covered by the PSD).

30 According to the OECD Commentary on Article 2, para. 6: "The list is not exhaustive. It serves to illustrate the preceding paragraphs of the Article. In principle, however, it will be a complete list of taxes imposed in each State at the time of signature and covered by the Convention. This paragraph lists the taxes in force at the time of signature of the Convention". As noted by Lang, however, the approach taken in the OECD Commentary seems rather contradictory. See M. Lang, 'Taxes Covered – What is a Tax according to Article 2 of the OECD Model?' (2005) Bulletin for International Taxation, issue 6, 220. On this point, see also M. Tenore, 'Taxes Covered: The OECD Model (2010) versus EU Directives', (2012) Bulletin for International Taxation, issue 6, 4.

Another observation concerns the relationship between the taxes listed in Annex I, Part B PSD and the possibility for Member States to collect taxes which have different nomenclature, yet prove to be substantially identical to those. Indeed, as mentioned, the function of the exhaustive list of the annex is to promote legal certainty by expressly defining the scope of application of the Parent-Subsidiary Directive, while ensuring that the broader objective of avoiding international double taxation on intra-EU profit distributions is attained. This therefore means that the fact that the list is exhaustive cannot imply that Member States may circumvent the limitations provided for by the Parent-Subsidiary Directive by introducing substitute taxes which have in essence identical features of the substituted taxes listed in Annex I, Part B PSD, as this would end up hindering the very objective of the Parent-Subsidiary Directive. **2.046**

This issue was analysed in the *Epson Europe*[31] case, in which the CJEU was asked to clarify whether the limitations on withholding taxation imposed by the Parent-Subsidiary Directive were limited to those taxes expressly listed in Annex I, Part B PSD, or whether they applied to any substantially similar taxes. **2.047**

More specifically, the preliminary ruling request concerned whether the Parent-Subsidiary Directive should be interpreted as meaning that the limitations on withholding taxes (*illo tempore* set at 15% and 10% due to the derogation granted to Portugal; see Chapter 7) referred only to the levying of corporate taxes in Portugal or, rather, it should extend to any other taxes on the income from shares, levied on dividends, regardless of the legislative instrument which provides for it. Put simply, the request essentially asked whether the limitations concerned any taxes, of whatever nature and however described, that take the form of a withholding tax on dividends distributed by subsidiaries located in a Member State to a parent company located in another Member State. **2.048**

In this respect, the CJEU clarified in *Epson Europe* that the term "withholding tax" should not be limited to certain specific types of national taxation and that the list referred to in Article 2(a)(iii) PSD identifies the national taxes to which the companies are normally subject in their Member State for the purpose of identifying the application scope of the Parent-Subsidiary Directive. However, as per paragraph 22 of *Epson Europe*, "it should not be inferred from **2.049**

31 Case C-375/98 Epson Europe [2000] ECLI:EU:C:2000:302.

this provision that other taxes having the same effect are authorised, particularly since the final part of Article 2 PSD refers expressly to 'any other tax which may be substituted for any of the above taxes'".

2.050 Aside from the issues mentioned above, the most debated aspect likely concerns the possibility of being exempt from (income) taxes in the Member State of residence (or, in any case, the existence of an option). In this respect, it should be noted that not only the Parent-Subsidiary Directive is not applicable to those cases where the company is exempt from taxes in that Member State, but also to those situations where the internal tax legislation grants the taxpayer the possibility to opt for an exemption from the tax contained in the Annex I, Part B PSD (i.e. regardless of the actual exercise of this option). That condition was the subject of an important CJEU decision in 2017, namely the *Wereldhave*[32] case.

2.051 *Wereldhave* concerned the distribution of profits made in 1999 and 2000 by a Belgian company to its two Dutch shareholders. More specifically, it concerned the distribution of dividends from a Belgian real estate investment fund ("*société d'investissement à capital fixe immobilière*", or "*vastgoed beleggingsvennootschap met vast kapitaal*") to two Dutch real estate investment funds which benefitted from the so-called "FBI regime" ("*fiscale beleggingsinstellingen*") for Dutch income tax purposes.[33]

2.052 Against this factual and normative background, the Dutch shareholders applied for the withholding tax exemption on the grounds that the participation in the Belgian entity met all the requirements of the Belgian rules implementing the Parent-Subsidiary Directive, among which that the Dutch funds were to be regarded as "companies of a Member State" within the meaning of Article 106(5) of the Royal Decree implementing the Belgian Income Tax Code[34] (and hence within the meaning of the Parent-Subsidiary Directive). In the absence of a decision from the Belgian authorities within the six-month

32 Case C-448/15 Wereldhave [2017] ECLI:EU:C:2017:180.

33 The FBI regime substantially amounts to a tax transparency at the level of the vehicle, as if the shareholders had directly invested in real estate projects, thereby implying that no corporate taxes are levied at the level the vehicle, which benefits from a zero-tax rate, and taxation ultimately occurs at the investor's level.

34 Article 106(5) of the Royal Decree implementing the Belgian Income Tax Code states: "The levying of advance tax on income from investments shall be waived in full in respect of dividends paid by a Belgian subsidiary to a parent company of another Member State of the European Economic Community. However, the waiver shall not apply if the shares held by the parent company in respect of which the dividends are being paid do not represent a holding of at least 25% of the capital of the subsidiary and that minimum 25% holding is not, or has not been, held for an uninterrupted period of at least one year. For the purposes of the application of the first and second paragraphs, "subsidiary" and "parent company" shall mean subsidiaries and parent companies within the meaning of Directive [90/435]".

period following receipt of the applications, both the shareholders along with the Belgian investment fund brought an action before the Court of First Instance of Brussels, which ruled in favour of the applicants. The Belgian State appealed against that decision before the Court of Appeal of Brussels which stayed the proceeding and referred to the CJEU for a preliminary ruling.

The referring Court posed the following questions: **2.053**

- Whether the Parent-Subsidiary Directive should be construed as precluding a national rule that does not waive advance tax on income from investments in respect of dividend payments made by a Belgian subsidiary to a parent company established in the Netherlands that fulfils the condition of a minimum participating interest and the holding of such an interest, on the ground that the Netherlands parent company is a fiscal investment institution that is required to distribute all its profits to its shareholders and, subject to that provision, is eligible for the zero rate of corporation tax.
- Whether, in case the answer to the first question is in the negative, the freedom of establishment and the free movement of capital should be construed as precluding a national rule that does not waive Belgian advance tax on income from investments in respect of dividend payments made by a Belgian subsidiary to a parent company established in the Netherlands that fulfils the condition of a minimum participating interest and the holding of such an interest, on the ground that the Netherlands parent company is a fiscal investment institution that is required to pay all its profits to its shareholders and, subject to that provision, is eligible for the zero rate of corporation tax.

Hence, the main question referred to the CJEU essentially concerned the meaning to be attributed to the expression "company of a Member State means any company which: [. . .] is subject to one of the taxes listed in Annex I, Part B, *without the possibility of an option or of being exempt*, or to any other tax which may be substituted for any of those taxes" contained in Article 2(a)(iii) PSD. The two other conditions included in Article 2(a) PSD were not in dispute. **2.054**

For the sake of completeness, it may be useful to note that the second question was declared inadmissible by the CJEU due to the lack of sufficient factual and normative elements to establish the presence of a discriminatory treatment. **2.055**

In *Wereldhave*, the CJEU thus focused on whether being formally subject to a tax listed in the Parent-Subsidiary with the possibility of benefiting from a zero-tax rate is actually equivalent to a subjective exemption, in which case the second part of Article 2(a)(iii) PSD would certainly not be met. As per the CJEU's argument this provision consists of two different criteria: a positive **2.056** criterion (requiring that the company is formally subject to one of the taxes listed in Annex I, Part B PSD), and a negative criterion (requiring that the company is not exempt from such taxes and does not have the possibility of an option).[35]

2.057 The function of this provision is therefore to ensure that a company of a Member State is not only formally subject to one of the listed taxes, but is also liable for an actual tax liability. That interpretation is clear from the Advocate General's Opinion where it is stated: "The purpose of Directive 90/435 is to eliminate double taxation, which necessarily implies that tax is actually levied. To allow an exemption from a withholding tax where there is no actual tax charge in the country of residence would not serve this purpose and may constitute a means of avoiding tax altogether".[36]

2.058 The approach of the CJEU in *Wereldhave*, however, raises some concerns. A first observation concerns the purpose of the Parent-Subsidiary Directive. As per its third recital, the purpose of the Parent-Subsidiary Directive is to exempt profit distributions from withholding taxes and to eliminate double taxation at the level of the recipient company. The approach is therefore to ensure that income taxation occurs only once, precisely at the level of the subsidiary (i.e. in that Member State where the income originates). This is fully consistent with the aim of promoting a single market where intra-EU distributions are granted conditions which are substantially equivalent to domestic distributions. As mentioned in the fourth recital, the purpose of the Parent-Subsidiary Directive is at the same time to ensure neutrality between the two situations.

2.059 In other words, this means that the objective of avoiding double taxation across the European Union is not relevant *per se*, but rather it should be examined along with this broader objective.[37]

2.060 The CJEU seems to recognise that the Parent-Subsidiary Directive furthers the pursuit of this objective, as paragraph 39 of the *Wereldhave* decision states: "The mechanisms of that directive are therefore intended for situations in which, if they were not applied, the exercise by the Member States of their powers of taxation might lead to the profits distributed by the subsidiary company to the parent company being subject to double taxation". However, the

35 Case C-448/15 Wereldhave [2017] ECLI:EU:C:2017:180, paras 31-33.

36 Case C-448/15 Wereldhave, Opinion of Advocate General Campos Sánchez-Bordona [2016] ECLI:EU:C:2016:808, para. 27.

37 See P. Arginelli, 'The Subject-to-Tax Requirement in the EU Parent-Subsidiary Directive (2011/96)' (2017) European Taxation, issue 8, 336.

CJEU concludes by stating that this objective is not at risk whenever the company receiving the profit distribution is not subject to taxes in its Member State.

This statement conflicts with the terms of the recitals as the profits earned by the Belgian company in *Wereldhave* are in fact taxed twice. Namely, once at the time of their production (i.e. corporate taxes) and once again at the time of the distribution to the shareholders (i.e. withholding taxes). **2.061**

By embracing the CJEU approach as in *Wereldhave*, therefore, one may be ultimately convinced that the only form of intra-EU (economic) double taxation that the Parent-Subsidiary Directive aims to avert is that concerning the application of corporate taxes, and not that involving withholdings tax on outgoing dividends. This approach does not seem coherent, as withholding taxes are essentially a form of advance taxation with respect to corporate taxes which will then be collected at the level of the recipient company. It is no accident, indeed, that withholding taxes are referred to in *Wereldhave* as "advance tax on investment income". **2.062**

More evidently, the statement of the CJEU in paragraph 39 conflicts with the search for neutrality altogether, as in the case of domestic distribution withholding taxes would not have been applied even if the recipient company had been an exempt entity. Put simply, this approach does not guarantee neutrality (i.e. the application of the same conditions that would apply in a domestic situation). **2.063**

The normative path to ensure neutrality would be an amendment to Article 2 PSD, such as to remove the requirement of being subject to corporate taxes on the side of the parent company when it comes to withholding taxes. Therefore, the resulting (normative) scenario should be the following: **2.064**

- For the purposes of the exemption from corporate taxes on the side of the parent company, it should be required that the distributing company is subject to corporate tax in its Member State (without the possibility of exemption or option), and that the parent company is also subject to corporate taxes in its Member State, as it would make little sense to grant the PSD-exemption to a taxpayer which is already exempt as a result of domestic tax rules.
- For the purposes of the exemption from withholding taxes at source, it should be required that the distributing company is effectively subject to corporate taxes in its Member State, and that the parent company is simply liable to tax, and hence

a tax resident in the Member State where established (as this would avoid that the withholding tax exemption ends up being available to non-EU companies).[38]

2.065 In this case, the objectives represented in the recitals above would be effectively pursued, given that intra-EU distributions would be granted the same conditions as internal distributions (i.e. corporate taxation applied only once, at the level of the subsidiary).

2.066 Another issue concerns the specific case of *Wereldhave*. In particular, if the dividends received by the Dutch funds had not been distributed to the members of the Dutch funds, the Parent-Subsidiary Directive would have been applicable. In this respect, paragraph 33 of the *Wereldhave* decision reads as follows: "Although, formally, a company which is subject to tax at a zero rate, provided that all of its profits are paid to its shareholders, is not exempt from that tax, it is, in practical terms, in the same situation as the one which Article 2(c) of Directive 90/435 seeks to exclude, that is to say, a situation in which it is not liable to pay that tax".

2.067 The approach of disregarding the context in which the profit distribution took place does not seem to be the best way possible to address the issue, to say the least, since, especially in the case where the shareholders are resident in the same Member State, there is no way to avoid corporate taxes and there does not seem to be any room for tax planning opportunities. That is to say, the income is taxed in any case, either at the level of the funds or in the hands of the shareholders.

2.068 In this regard, let us assume that the Dutch funds had not distributed the profits received from the Belgian subsidiary. The FBI regime would not have been applicable in the Netherlands and, therefore, the Dutch funds would have been subject to corporate taxes. Consequently, the Parent-Subsidiary Directive would have been applicable both with regard to the exemption from withholding taxes in Belgium and with regard to corporate taxes to be paid in the Netherlands, as the profit distribution would have met all the requirements for being exempted. Hence, in such a scenario the tax treatment would have presumably been more favourable than that granted under the Parent-Subsidiary Directive in the event of the profits being passed along to the shareholders of the Dutch funds, at least according to the approach adopted by the CJEU.

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38 As also suggested by Arginelli. See P. Arginelli, 'The Subject-to-Tax Requirement in the EU Parent-Subsidiary Directive (2011/96)' (2017) European Taxation, issue 8, 336.

Furthermore, what is even more striking is that the profits would not even have been subject to taxes in the hands of the shareholders, if resident in the Netherlands or in another Member State, since once again the directive would have been applied both with regard to withholding taxes and corporate taxes. **2.069**

In light of the above, a solution could be to rethink the subject-to-tax requirement at the recipient level. Not surprisingly, the OECD Model Convention (as mentioned in section 2.2) does not seem to require that the exemption from withholding taxes be subordinated to compliance with this requirement either at the level of the recipient or at the level of the distributing entity. The Parent-Subsidiary Directive could therefore move toward the same direction. **2.070**

D. PERMANENT ESTABLISHMENTS

As mentioned, the Parent-Subsidiary Directive not only applies to profit distributions made by a company of a Member State to a company of another Member State, but also to distributions of profits made by a company of a Member State to a permanent establishment located in another Member State. However, for the exemptions to be applicable, it is necessary that the definition of permanent establishment contained in Article 2(b) PSD is met. **2.071**

The first part of the definition requires that the permanent establishment constitutes "a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on". Therefore, the definition seems to exclude permanent establishments located outside the European Union of companies established in a Member State. At the same time, it also appears to exclude permanent establishments located in the European Union, yet belonging to a company established in a non-EU State. **2.072**

The second part of the definition adds a further condition, namely that the profits of such permanent establishment are subject to tax in the Member State where the place of business is located. **2.073**

In that regard, whenever a tax treaty between the Member State of the permanent establishment and the State where the head office is located is enforced, the provision essentially requires that the tax treaty does not restrict the taxing powers of the source state, as in such a situation the objective of the **2.074**

Parent-Subsidiary Directive would risk being compromised. Accordingly, where the Member State of the permanent establishment has not concluded any relevant tax treaty, the provision plainly requires that the permanent establishment be subject to tax in that Member State by virtue of the applicable domestic tax law.

2.075 The definition of permanent establishment is discussed in more detail in Chapter 4.

3

ARTICLE 1(2) – 4: ABUSE

Jean-Philippe Van West

2. **Member States shall not grant the benefits of this Directive to an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.**
3. **For the purposes of paragraph 2, an arrangement or a series of arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.**
4. **This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion, tax fraud or abuse.**

COMMENTARY

A. BACKGROUND

3.001 Abuse of the Parent Subsidiary Directive is a topic that has received, as will be demonstrated further in this contribution, particular attention from the European legislator, the CJEU and scholars. Initially, Article 1(2) of the Parent-Subsidiary Directive of 23 July 1990[1] contained the following wording:

> This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse.[2]

3.002 According to the CJEU, which on several occasions had the opportunity to clarify its scope, this provision reflects the general principle of EU law that any abuse of rights is prohibited.[3] Furthermore, according to the CJEU, Article 1(2) of the Parent-Subsidiary Directive needs to be interpreted strictly because it is regarded as an exception to the general rules laid down in the Parent Subsidiary Directive.[4] In its landmark decision of 26 February 2019, dubbed the "Danish Cases",[5] the CJEU furthermore held that even if national law does not contain rules which may be interpreted in compliance with Article 1(2) of Directive 90/435, this does not mean that the national authorities and courts are prevented from refusing to grant the advantage derived from the right of exemption provided for in Article 5 of the PSD in the event of fraud or abuse of rights.[6] Otherwise said, where the initial wording of Article 1(2) PSD does not oblige Member States to introduce domestic or agreement-based provisions to prevent fraud or abuse, the absence of such provisions does not mean that Member States cannot deny the exemption of withholding tax as provided for under Article 5 of the Parent Subsidiary Directive in cases of fraud or abuse of rights. On the contrary, in the Danish PSD Cases, the CJEU

1 Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [1990] OJ L225/6.

2 Council Directive 90/435/EEC, art 1(2).

3 Case C-6/16 Eqiom and Enka [2017] ECLI:EU:C:2017:641, para 26.

4 Case C-6/16 Eqiom and Enka [2017] ECLI:EU:C:2017:641; Joined Cases C-504/16 and C-613/16 Deister Holding AG and Juhler Holding A/S v Bundeszentralamt für Steuern [2017] ECLI:EU:C:2017:1009.

5 Joined Cases C-116/16 and C-117/16 T Danmark and Y Denmark Aps v Skatteministeriet [2019] ECLI:EU:C:2019:135 and Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16 N Luxembourg 1 and Others v Skatteministeriet [2019] ECLI:EU:C:2019:134. The former cases dealt with abuse of the PSD and will hereinafter be referred to as the 'Danish PSD Cases'. The latter cases dealt with abuse of the IRD and will hereinafter be referred to as the 'Danish IRD Cases'.

6 Danish PSD Cases, para 89.

held that the general principle of EU law that abusive practices are prohibited obliges Member States to refuse to grant entitlement to rights provided for by the Parent-Subsidiary Directive where they are invoked for fraudulent or abusive ends.[7]

The work of the OECD on Base Erosion and Profit Shifting ("the BEPS Project") inspired the European legislator to amend Article 1(2) of the Parent Subsidiary Directive and through the adoption of Council Directive 2015/121 of 27 January 2015 a general anti-avoidance rule was inserted in the Parent Subsidiary Directive ("the PSD GAAR"). Since then, Articles 1(2) and 1(3) contain the wording of the PSD GAAR, and the initial wording of Article 1(2) is now included in Article 1(4) PSD[8]: **3.003**

2. *Member States shall not grant the benefits of this Directive to an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.*
3. *For the purposes of paragraph 2, an arrangement or a series of arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.*
4. *This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion, tax fraud or abuse.*

In its judgment of 3 April 2025 in Nordcurrent UAB,[9] the CJEU had the chance to rule on the application of the PSD GAAR. In this judgment, the CJEU decided that, for the purpose of interpreting this provision, the clarifications provided by the CJEU in respect of the general principle of the **3.004**

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7 Danish PSD Cases, para 83. Note that the CJEU is criticised in literature for this position. W. Schön, 'The Concept of Abuse of Law in European Taxation: A Methodological and Constitutional Perspective' (November 20, 2019), Working Paper of the Max Planck Institute for Tax Law and Public Finance No. 2019-18, Available at SSRN: https://ssrn.com/abstract=3490489. Schön writes among other that "Given the fact that the relevant directives emphasize the elective character of the afore-mentioned anti-avoidance clauses, and given the fact that the Danish legislator deliberately did not apply this election, it seems strange to rewrite the clear situation under domestic law by recurring to a general anti-abuse principle which has been falsely promoted to the rank of the fundamental rights and the fundamental freedoms".

8 If one compares the wording of the initial Article 1(2) PSD with the wording of Article 1(4) PSD after the adoption of Council Directive 2015/121 of 27 January 2015, one notices that the initial wording referred to "for the prevention of fraud or abuse" whereas after the amendment the wording "for the prevention of tax evasion, tax fraud or abuse" is used (emphasis added). The author agrees with Marres that this change in wording does not change the meaning of the provision. O. Marres, 'The Parent-Subsidiary Directive' in B. Terra et al. (eds), *European Tax Law - Student edition*, (Wolters Kluwer 2022), no. 16.8.2.

9 Case C-228/24 Nordcurrent Group UAB [2019] ECLI:EU:C:2025:239 § 23. The case will hereinafter be referred to as Nordcurrent Group UAB.

prohibition of abuse in its case law relating to the PSD are also relevant.[10] Hence, one cannot ignore the general principle of the prohibition of abuse of rights as developed in the case law of the CJEU when interpreting and applying the PSD GAAR. Given this position of the author and the decision of the CJEU that Article 1(4) PSD reflects the general principle of EU law that any abuse of rights is prohibited, the remainder of this contribution first provides a brief overview of the development of the general principle of the prohibition of abuse of rights as seen in the case law of the CJEU (Section B) and continues with an analysis of the PSD GAAR (Section C). Next, the relationship between the general principle of prohibition of abuse of EU law and the PSD GAAR is discussed (Section D) followed by a discussion of the relevance of Article 1(4) of the PSD (Section E).

B. THE GENERAL PRINCIPLE OF PROHIBITION OF ABUSE OF EU LAW: AN INTRODUCTION

3.005 On several occasions, the development of the general principle of prohibition of abuse of EU law and the application of it in the area of direct taxation has been described in tax literature.[11] It is generally accepted that this principle was developed outside the area of taxation, and regarding taxation, was first accepted in case law concerning VAT before it also found its way into the case law on direct taxation.[12] Some of the landmark cases include Van Binsbergen[13]; Emsland Starke[14] in which the CJEU introduced its two-prong abuse test consisting of an objective and a subjective element; Halifax which was the first VAT case in which the CJEU applied its two-prong abuse test[15];

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10 Nordcurrent Group UAB, para. 23.

11 See for example R. de la Feria, 'EU General Anti-(Tax) Avoidance Mechanisms: From GAAP to GAAR' (1 November 2019), SSRN Scholarly Paper, https://doi.org/10.2139/ssrn.3485784; K. Lenaerts, 'Le Juge de l'Union, Promoteur de La Lutte Contre l'abus de Droit En Matière Fiscale' (2019) *Revue Générale Du Contentieux Fiscal* 2019/6, 433–49; L. De Broe and S. Gommers, *Global Tax Treaty Commentaries – Article 29: Entitlement to Benefits (European Union)* (IBFD 2019). For literature before the Danish PSD Cases see for example; D. Weber, 'Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ – Part 1' (2013) European Taxation, issue 6, 251; D. Weber, 'Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ – Part 2' (2013) European Taxation, issue 7, 313; A. Zalasiński, 'Proportionality of Anti-Avoidance and Anti-Abuse Measures in the ECJ's Direct Tax Case Law' (2007) Intertax, issue 5, 310-321.

12 See the literature in the previous footnote.

13 Case 33/74 Van Binsbergen v Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid [1974] ECR 1299, ECLI:EU:C:1974:131.

14 Case C-110/99 Emsland-Stärke GmbH v Hauptzollamt Hamburg-Jonas [2000] ECLI:EU:C:2000:695.

15 Case C-255/02 Halifax plc and Others v Commissioners of Customs & Excise [2006] ECLI:EU:C:2006:121.

Cadburry-Schweppes which was the first direct tax case in which the CJEU applied its two-prong abuse test; Italmoda[16] and Cussens,[17] two VAT cases in which the CJEU stated that a general abuse principle exists; and the Danish Cases[18] in which the CJEU confirmed the existence of such principle for the first time in cases involving direct taxation.

According to the case law of the CJEU, proof of an abusive practice entails a two-prong test consisting of an objective element (a combination of objective circumstances in which, despite formal observance of the conditions laid down by the EU rules, the purpose of those rules has not been achieved) and a subjective element (the intention to obtain an advantage from the EU rules by artificially creating the conditions laid down for obtaining it).[19] **3.006**

C. THE PSD GAAR

1. The origin of the PSD GAAR and its aim

The same year that the G20 leaders discussed the need to prevent base erosion and profit shifting at their meeting in Mexico,[20] the European Commission released its action plan to strengthen the fight against tax fraud and abuse.[21] [22] Two of the actions included in this action plan to be taken in the short term (i.e., in 2013) concerned the PSD. According to the plan, the PSD should be revised to address hybrid mismatch arrangements, and the anti-abuse provision of the PSD should be reviewed. Note that according to the plan the anti-abuse provisions included in the EU Interest and Royalty Directive[23] and the **3.007**

16 Case C-131/13 Staatssecretaris van Financiën v Schoenimport 'Italmoda' Mariano Previti vof and Others [2014] ECLI:EU:C:2014:2455.

17 Case C-251/16 Edward Cussens and Others v T.G. Brosnan [2017] ECLI:EU:C:2017:881.

18 Danish IRD Cases; Danish PSD Cases.

19 Danish PSD Cases, para 97 and Danish IRD Cases, para 124 with further references. For a general discussion of the two-pronged test, the author refers to the literature referred to under footnote 11.

20 G20, *G20 Leaders' Declaration* (Los Cabos, 19 June 2012).

21 Communication from the Commission to the European Parliament and the Council: An Action Plan to Strengthen the Fight Against Tax Fraud and Tax Evasion, COM(2012) 722 final (6 December 2012).

22 For more details on the origin of the PSD GAAR, see O. Marres and I. de Groot, 'The General Anti-Abuse Clause in the EU Parent-Subsidiary Directive' in D. Weber (ed), *EU Law and the Building of Global Supranational Tax Law : EU BEPS and State Aid*, (IBFD 2017); D. Weber, 'The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive: Background, Impact, Applicability, Purpose and Effect' (2016) Intertax, issue 2, 98–99.

23 Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Companies of Different Member States [2003] OJ L157/49.

EU Merger Directive[24] should be reviewed as well. So far this, unlike is the case for the PSD GAAR, didn't happen yet.

3.008 On 25 November 2013, the European Commission took further action to strengthen the fight against fraud and abuse and published a proposal to amend the PSD to address abusive transactions.[25] The proposal contained measures to include a general anti-abuse provision in the PSD and a specific anti-abuse rule addressing certain hybrid financial mismatch arrangements. Agreement was reached rather swiftly on the latter rule resulting in the publication of Directive 2014/86/EU in July 2014 which introduced Article 4(1)(a) in the PSD.[26] However, it took the EU Member States longer to reach the required unanimity on the PSD GAAR, and only in January 2015, about half a year later, Directive 2015/121 was adopted.[27] A comparison of the proposed wording of the provision included in the November 2013 proposal and the text of the PSD GAAR that was finally adopted demonstrates that there are important differences between the two texts:

3.009 Important differences include, among others, that the proposal of November 2013 refers to "the essential purpose of obtaining an improper tax advantage," whereas the provision finally agreed upon uses the wording "put into place for the main purpose or one of the main purposes of obtaining a tax advantage". Additionally, the proposal of November 2013 included a list of potentially artificial transactions, which is not included in the finally adopted text. It thus seems that the EU Member States did not have objections against the inclusion of a GAAR in the PSD, but rather against the proposed wording in the November 2013 proposal.

3.010 The preamble to Directive 2015/121 explains why the PSD GAAR was introduced into the PSD. First, although some Member States have general

24 Council Directive 2009/133/EC of 19 October 2009 on the Common System of Taxation Applicable to Mergers, Divisions, Partial Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States and to the Transfer of the Registered Office of an SE or SCE between Member States (Codified Version) [2009] OJ L310/34.

25 Proposal for a Council Directive amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, COM(2013) 814 final (25 November 2013) https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0814:FIN:EN:PDF.

26 Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States [2014] OJ L219, 40–41.

27 Council Directive 2015/121 of 27 January 2015 amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States [2015] OJ L21/1 (hereafter 'Directive 2015/121').

Table 3.1 *XXX*

Proposal PSD GAAR 25 November 2013	PSD GAAR adopted
1. Member States shall withdraw the benefit of this directive in the case of an artificial arrangement or an artificial series of arrangements which has been put into place for the essential purpose of obtaining an improper tax advantage under this directive and which defeats the object, spirit and purpose of the tax provisions invoked. 2. A transaction, scheme, action, operation, agreement, understanding, promise, or undertaking is an artificial arrangement or a part of an artificial series of arrangements where it does not reflect economic reality. In determining whether an arrangement or series of arrangements is artificial, Member States shall ascertain, in particular, whether they involve one or more of the following situations: (a) the legal characterisation of the individual steps which an arrangement consists of is inconsistent with the legal substance of the arrangement as a whole; (b) the arrangement is carried out in a manner which would not ordinarily be used in a reasonable business conduct; (c) the arrangement includes elements which have the effect of offsetting or cancelling each other; (d) the transactions concluded are circular in nature; (e) the arrangement results in a significant tax benefit which is not reflected in the business risks undertaken by the taxpayer or its cash flows.	2. Member States shall not grant the benefits of this Directive to an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part. 3. For the purposes of paragraph 2, an arrangement or a series of arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

provisions in place to tackle abusive situations, "those provisions may have different levels of severity and, in any case, they are designed to reflect the specificities of each Member State's tax system".[28] Second, some Member States did not have any domestic or agreement-based provisions for the prevention of abuse.[29] The inclusion of the PSD GAAR would hence "be very helpful to

28 Directive 2015/121, recital 4.
29 Directive 2015/121, recital 4.

prevent misuse of that Directive and to ensure greater consistency in its application in different Member States".[30]

3.011 Against this backdrop, the PSD GAAR contains, as can be derived from the use of the wording "Member States shall not grant the benefits of this Directive (...)" an obligation for Member States to deny the benefits of the PSD in cases of abuse.[31] The application of the PSD GAAR should be proportionate and should address "arrangement or a series of arrangements which are not genuine, that is, which do not reflect economic reality".[32]

3.012 It is pointed out in the literature that the PSD GAAR serves as a de minimis rule and that Member States should have a GAAR in place that is at least as strict as the PSD GAAR.[33] This does not mean that Member States are unrestricted to adopt anti-abuse measures that go beyond the scope of the PSD GAAR.[34] In this regard, the case law of the CJEU on old Article 1(2) PSD, now included in Article 1(4) PSD, is also of relevance, illustrating that there are limits to the sovereignty of Member States in adopting anti-abuse measures. As a reminder, with respect to this provision, the CJEU decided that it reflects the general principle of EU law that any abuse of rights is prohibited, and that old Article 1(2) of the Parent-Subsidiary Directive needs to be interpreted strictly because it is regarded as an exception to the general rules laid down in the Parent Subsidiary Directive.[35]

2. Constituent elements of the PSD GAAR

(a) General

3.013 Since the PSD GAAR codifies the principle of prohibition of abuse of EU law, it does not come as a surprise that the constituent elements of the PSD GAAR

30 Directive 2015/121, recital 5.

31 De Broe and Beckers point out that signs of a policy shift and the mandatory inclusion and application of a GAAR could already be found in the proposal for the introduction of a Financial Transaction Tax of 2011 and the second proposal for the introduction of a Financial Transaction Tax of 2013. See respectively Article 11(1) of the *Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC*, COM(2011) 594 final (28 September 2011), and Article 13 of the *Proposal for a Council Directive Implementing Enhanced Cooperation in the Area of Financial Transaction Tax*, COM(2013) 71 final (14 February 2013) and L. De Broe and D. Beckers, 'The General Anti-Abuse Rule of the Anti-Tax Avoidance Directive: An Analysis Against the Wider Perspective of the European Court of Justice's Case Law on Abuse of EU Law' (2017) EC Tax Review, issue 3, 140.

32 Directive 2015/121, recital 6.

33 F. Debelva and J. Luts, 'The General Anti-Abuse Rule of the Parent-Subsidiary Directive' (2015) European Taxation, issue 6, 224; Weber, 'The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive' 102–3.

34 Weber, 'The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive' 102–3.

35 See above Section A. See also in more detail Section D.2.b.

are similar to those of said general principle as developed by the CJEU in its case law. Similar but not necessarily identical, because there are some important nuances. Like the general principle, the PSD GAAR contains an objective and a subjective test. However, a reading of the PSD GAAR seems to indicate that there is a third test, the "genuine nature" test, according to which, for abuse to exist, the arrangement must not be genuine having regard to all relevant facts and circumstances. Each of these three tests will be discussed consecutively in more detail. Before, however, four remarks must be made.

Given the important nuances between the wording of the PSD GAAR and the principle of prohibition of abuse of EU law as developed by the CJEU in its case law, uncertainty remains, however, on the exact scope of the PSD GAAR and its interaction with this general principle (however, in Section D the author will develop his views thereby taking into account the decision of the CJEU in Nordcurrent UAB where the CJEU stated that the clarifications provided by the CJEU in respect of the general principle of the prohibition of abuse in its case law relating to the PSD are relevant for the interpretation of the PSD GAAR). Second, it can be derived from the wording of the PSD GAAR that the aforementioned three tests must be met cumulatively in order for the conditions for the provision to apply to be fulfilled.[36] However, as will be further explained when discussing the different tests, there is a certain overlap and interaction between the three tests,[37] and depending on the interpretation given to each of the three tests and their interaction, it can be questioned if some of the tests are not almost de facto fulfilled or redundant. Illustrative in this regard is that the CJEU in in Nordcurrent UAB[38] stated that in the light of the wording of the anti-abuse provision set out in Article 1(2) and (3) of the PSD two conditions must be satisfied in order for the benefits of that directive to be denied. According to the CJEU there are thus only two conditions. Hence, it is important to remind that one should be careful and not interpret the three tests too literally. Third, according to the wording of the PSD GAAR, Member States shall not grant the benefits of the PSD in cases of an abusive *arrangement or series of arrangements*, thereby not defining **3.014**

36 Debelva and Luts, 'The General Anti-Abuse Rule of the Parent-Subsidiary Directive' 224.

37 See for example Debelva and Luts who are of the opinion that although one can make a theoretical distinction between the objective and subjective test of the PSD GAAR it will often be difficult to distinguish between the two in practice Debelva and Luts, 227. See also De Broe and Beckers who come to the conclusion regarding the genuine nature test of the ATAD GAAR of which the wording resembles the wording of the PSD GAAR that this test has little added value if the subjective and objective tests are applied correctly. De Broe and Beckers, 'The General Anti-Abuse Rule of the Anti-Tax Avoidance Directive' 143.

38 Nordcurrent Group UAB, para. 45.

the terms "arrangement" or "series of arrangements". The author agrees with Debelva and Luts, and Weber that based on the legislative history it can be derived that these terms include *a transaction, scheme, action, operation, agreement, understanding, promise, or undertaking*.[39] Fourth, the PSD GAAR was adopted more than a decade ago and several important developments have taken place since then, such as the decisions of the CJEU in the Danish Cases. However, several of the academic articles referred to on the PSD GAAR were released shortly after the adoption of the PSD GAAR and did thus not take into account the later developments. Hence, the literature referred to does not necessarily reflect the current views of the cited authors.[40]

(b) Subjective test: the main purpose of one of the main purposes

3.015 The subjective test (also referred to as the motive test) entails that the main purpose or one of the main purposes for putting in place an arrangement or a series of arrangements was to obtain a tax advantage. This wording seems to suggest that the purposes of an arrangement or a series of arrangements must be identified, with a distinction made between main purpose(s) and auxiliary purpose(s). It is debated in literature how the wording "the main purpose or one of the main purposes" should be understood.

3.016 According to Debelva and Luts, it is fundamentally unacceptable that the PSD GAAR would lower the subjective threshold to "one of the main purposes".[41] They argue, among others, that this is hard to align with the object and purpose of the PSD and that since taxes are often an important cost that are taken into account when making business decisions,[42] this threshold is too low. They argue that the wording "one of the main purposes" should be interpreted as the sole or predominant purpose because the wording of the PSD GAAR resembles the wording of the anti-abuse provision of the Merger Directive[43]

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39 This is the wording used in the second paragraph of the November 2013 proposal. See the table above and Debelva and Luts, 'The General Anti-Abuse Rule of the Parent-Subsidiary Directive' 224; Weber, 'The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive' 111–12.

40 Obviously, authors might always change their minds, and this fourth remark hence applies to any situation, but it is useful to remind the reader of this.

41 Debelva and Luts, 'The General Anti-Abuse Rule of the Parent-Subsidiary Directive' 225.

42 Note that De Wilde comes to the conclusion regarding the interpretation of the subjective test of the ATAD GAAR, of which the wording is almost identical to the PSD GAAR, that the subjective test of the ATAD GAAR will in principle always be met given that taxes are an important cost and are something to be optimised just like all business costs. M. De Wilde, 'The ATAD's GAAR: A Pandora's Box?' in D. Weber and P. Pistone (eds), *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* (IBFD 2018).

43 The anti-abuse provision of the Merger Directive refers to "principal objective or one of its principal objectives".

and that it can be derived from the case law of the CJEU on the interpretation of the anti-abuse law of the Merger Directive that only transactions where the sole or predominant purpose is obtaining a tax benefit provided for under the Merger Directive fall within the scope of the anti-abuse provision.[44] Marres is of the opinion that the CJEU will probably interpret the subjective test of the PSD GAAR in the same way as it interpreted the anti-abuse provisions of the Merger Directive because in the case law of the CJEU on the interpretation of the anti-abuse provision of the Merger Directive the CJEU decided that the anti-abuse provision of the Merger Directive forms an expression of the general principle of prohibition of abuse of rights.[45] Some important arguments against such an interpretation of the wording "the main purpose or one of the main purposes" are that it seems to deviate from a textual interpretation and that a historical interpretation also argues in favour of a broader interpretation.[46] In addition, in the Danish Cases, the CJEU explicitly referred to the essential aim in addition to the sole aim.[47]

In its decision in Nordcurrent UAB on the application of the PSD GAAR, **3.017**
the CJEU is not consistent in its wording.[48] It first refers to the main purpose or one of the main purposes when establishing the two conditions of the anti-abuse test, but in the next paragraph, it only refers to the main purpose. Later in its decision, the CJEU refers again to the main or one of the main purposes.[49] The facts of the Nordcurrent UAB case can be summarised as follows.

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44 Case C-331/05 *Kofoed* [2007] ECLI:EU:C:2007:408; Case C-126/10 *Foggia – Sociedade Gestora de Participações Sociais SA v Secretário de Estado dos Assuntos Fiscais* [2011] ECLI:EU:C:2011:718.

45 P. Wattel, 'European Union - Non-Discrimination à La Cour: The ECJ's (Lack of) Comparability Analysis in Direct Tax Cases' (2015) European Taxation, 542.

46 The argument is then that the version of November 2014 used the wording essential purpose and that it was then clearly the intention of the European legislator to broaden the subjective test to the main purpose or one of the main purposes of obtaining a tax advantage.

47 Danish PSD Cases, para 79: "To permit the setting up of financial arrangements whose *sole aim* is to benefit from the tax advantages resulting from the application of Directive 90/435 would not be consistent with such objectives and, on the contrary, would undermine the effective functioning of the internal market by distorting the conditions of competition". As the Advocate-General has, in essence, observed in point 51 of her Opinion in Case C-116/16, that would also be the case even if the transactions at issue do not exclusively pursue such an aim, as "the Court has held that the principle that abusive practices are prohibited applies, in tax matters, where the accrual of a tax advantage constitutes *the essential aim* of the transactions at issue" (emphasis added).

48 Nordcurrent Group UAB, para. 45: "Second, the arrangement must have been put into place with *the main purpose or one of its main purposes* being that of obtaining a tax advantage that defeats the object of that directive." Para. 46: "Therefore, it is not sufficient to establish that the arrangement was not put into place for valid commercial reasons reflecting economic reality, which corresponds to the definition of a non-genuine arrangement set out in Article 1(3) of Directive 2011/96. It is also necessary, in accordance with Article 1(2) of that directive, for the arrangement to have been put into place *with the main purpose* of obtaining a tax advantage that defeats the object or purpose of that directive" (emphasis added).

49 Nordcurrent Group UAB, para. 54.

3.018 Nordcurrent UAB concerns a dispute between "Nordcurrent group" UAB, a Lithuanian video game company, and the Lithuanian tax authorities over the application of the dividend exemption under the PSD to dividends received from a UK subsidiary, Nordcurrent Ltd. During a tax audit, the Lithuanian tax authorities denied the tax exemption for dividends received in 2018 and 2019 because they are of the opinion that the UK subsidiary constituted a non-genuine arrangement lacking valid commercial reasons. According to the tax authorities, the existence of a non-genuine arrangement was demonstrated by the fact that for 2018 and 2019 the UK subsidiary did not have human resources corresponding to the large number of games distributed, customers and sales channels; the only employee of that subsidiary was its director who at the same time managed seven other companies; and the subsidiary had neither its own place of business nor any tangible assets in the United Kingdom and a large number of undertakings (97 110) were registered at the same address as the subsidiary.

3.019 Based on this, the tax authorities were of the opinion that the activities relating to the creation and distribution of games by the UK subsidiary had been carried out by the employees of the parent company who had access to the platforms used by the subsidiary for advertising and games.[50] The taxpayer held that the UK subsidiary provided it with a commercial advantage and was not a non-genuine arrangement. According to the taxpayer, the UK subsidiary was necessary as an intermediary between the taxpayer and advertising and game distribution platforms because in the years concerned the taxpayer had no opportunity to sell games directly from Lithuania. The taxpayer further argued that given the business structure, i.e. the distribution of electronic games, the subsidiary did not need physical premises. Furthermore, the conclusion of standard agreements for game distribution or the purchase of advertising by the subsidiary did not require staff other than the director.[51] The following observations can be made.

3.020 First, the CJEU provides some clarity on what constitutes a tax advantage. Interesting in this regard was that the taxpayer argued that there was no actual tax advantage because the applicable corporate income tax rate in the UK (24%) was higher than the rate applicable in Lithuania (15%), and consequently, the profits of the subsidiary were subject to a higher tax rate in the UK compared to the situation if they were obtained directly by the Lithuanian

50 Nordcurrent Group UAB, para. 11-14.
51 Nordcurrent Group UAB, para. 15-16.

parent entity.[52] The CJEU notes that the term "tax advantage" is not defined in the PSD and hence the question arises how this term must be interpreted. In the case at hand, does the term only include the tax exemption referred to in the PSD, or should the term be interpreted in a broader sense by taking into account whether, in the light of the difference in the rate of corporation tax between the United Kingdom and Lithuania, that company made a tax saving.[53] The CJEU decides in favour of such a broader approach. The fact that the profits made by the subsidiary were subject in the UK to a tax rate that is higher than the rate that would be applicable if the profits were taxable in Lithuania is a relevant factor for assessing whether the main purpose or one of the main purposes of the subsidiary's existence was to benefit from a tax advantage for the purpose of the PSD GAAR.

It is interesting that the CJEU takes the position that the overall tax consequences of an arrangement (and thus not limited to the tax consequences of the PSD) should be taken into account, but does not go as far as to state that in the case at hand there was no tax advantage and hence the abuse test was not met. From the wording of the PSD GAAR, it can be derived that if a certain arrangement or series of arrangements does not lead to a tax advantage, such arrangement or series of arrangements should generally not fall within the scope of the PSD GAAR. A good argument in favour of the latter position is that it is hard to see how it would be put into place for the main purpose or one of the main purposes of obtaining a tax advantage.[54] Regarding the application of the WHT exemption under the PSD, one can think of the situation whereby a company established in a third country holds a participation in a company established in an EU Member State. If under an applicable double tax treaty between the third country and the EU Member State the WHT is reduced to 0%, interposing an intermediate holding company in another EU Member State it could be argued that this should generally not be regarded as an arrangement that frustrates the object and purpose of Article 5 PSD because without the interposition of the intermediate holding company there would be no WHT due either. In its decision in the Danish Cases however the CJEU found among others that it is immaterial that some of the beneficial owners of the dividends paid by the conduit company are resident for tax purposes in a third state which has concluded a double taxation convention with **3.021**

52 Nordcurrent Group UAB, para. 18.

53 Nordcurrent Group UAB, para. 51.

54 See also Weber, 'The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive' 110–11 and G. Kofler, 'Mutter-Tochter-Richtlinie' in Schaumburg, Englisch, and Dobratz (eds), *Europäisches Steuerrecht* (1st edn, Otto Schmidt 2024), 668.

the source Member State and that the existence of such a convention cannot in itself rule out an abuse of rights.[55]

3.022 Second, although it can be derived from among others the amending proposal of 2013 that one of the reasons for including the PSD GAAR was to address directive shopping, which is described as situations whereby companies invest through intermediary companies in EU Member States with no or restrictive anti-abuse provisions,[56] this does not mean that the PSD GAAR only targets tax planning structures involving conduit companies.[57] The CJEU refers among others to the Danish PSD Cases and states that it is clear from those cases that the situation of a conduit company is just one example of the application of the principle of the prohibition of abuse.[58] More generally, the CJEU stated that the wording of the PSD does not mean that the PSD GAAR is applicable only to specific situations or types of arrangements. On the contrary, the provisions require a holistic perspective consisting in identifying the potential non-genuine nature of an arrangement having regard to all relevant facts and circumstances, that arrangement being characterised by the absence of valid commercial reasons which reflect economic reality.[59]

3.023 Third, regarding the assessment of all relevant facts and circumstances and its timing, the CJEU clarified in its decision in Nordcurrent UAB that in a situation in which an arrangement consists of more than one step, all relevant facts and circumstances must be taken into account in order to establish that there are one or more steps which are not genuine.[60] One can thus not limit the analysis to just the dividend distribution.

3.024 Fourth, the author is of the opinion that the existing case law of the CJEU can provide useful guidance for the interpretation and application of the PSD GAAR, and that, as was done in the Danish Cases, the CJEU will work with indicators of abuse when it has the opportunity to rule on the interpretation of the PSD GAAR. The interaction between the general principle of

55 Danish PSD Cases, para 108. For criticism of that position of the CJEU see e.g. L. De Broe et al., 'Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases' (2019) EC Tax Review, issue 6, 284-285.

56 Proposal for a Council Directive amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, COM(2013) 814 final (25 November 2013), 4.

57 Weber, 'The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive' 116–17.

58 Nordcurrent Group UAB, para. 28.

59 Nordcurrent Group UAB, para. 25.

60 Nordcurrent Group UAB, para. 41.

prohibition of abuse of EU law and the PSD GAAR will be further discussed in Section 4.[61]

(c) Objective test: obtaining a tax advantage that defeats the object and purpose of the PSD

The objective test is fulfilled if a tax advantage is obtained that defeats the object or purpose of the PSD. Unlike the subjective test, the objective test in the PSD GAAR is very similar to the objective test usually applied by the CJEU.[62] Hence a conflict must exist between, on the one hand, the tax advantage obtained, and the object and purpose of the PSD on the other. **3.025**

The preamble to the PSD states that its objective is to: **3.026**

> to exempt dividends and other profit distributions paid by subsidiary companies to their parent companies from withholding taxes and to eliminate double taxation of such income at the level of the parent company[63]

Furthermore, the preamble provides that: **3.027**

> The grouping together of companies of different Member States may be necessary in order to create within the Union conditions analogous to those of an internal market and in order thus to ensure the effective functioning of such an internal market. Such operations should not to be hampered by restrictions, disadvantages or distortions arising in particular from the tax provisions of the Member States. It is therefore necessary, with respect to such grouping together of companies of different Member States, to provide for tax rules which are neutral from the point of view of competition, in order to allow enterprises to adapt to the requirements of the internal market, to increase their productivity and to improve their competitive strength at the international level.[64]

On several occasions, the CJEU referred to the object and purpose of the PSD in its case law. For example, in case C-6/16 – Eqiom the CJEU stated that: **3.028**

> the Parent-Subsidiary Directive seeks, by the introduction of a common tax system, to eliminate any disadvantage to cooperation between companies of different Member States as compared with cooperation between companies of the same Member State and thereby to facilitate the grouping together of companies at EU level. That directive thus seeks to ensure the neutrality, from the tax point of view, of the distribution of profits by a

61 Section 4 on the relation between the general principle of prohibition of abuse of EU law and the PSD GAAR.

62 See also Debelva and Luts, 'The General Anti-Abuse Rule of the Parent-Subsidiary Directive' 226.

63 Directive 2015/121, recital 3.

64 Directive 2015/121, recital 4.

company established in one Member State to its parent company established in another Member State.[65]

3.029 It can thus be concluded that the objective of the PSD is to facilitate the grouping of companies within the internal market and to ensure that profit distributions from subsidiaries established in one Member State (or permanent establishments) to parent entities established in another Member State are treated in the same way as profit distributions from subsidiaries to parent entities in a purely domestic context.[66]

3.030 The author concurs with Weber that although Article 1(2) PSD refers to the object and purpose in general, when determining whether the objective test is fulfilled also the object and purpose of the specific provisions at stake in an (alleged) abuse situation must be taken into consideration,[67] because these provisions determine the scope and limits of how the general aim of the PSD is achieved.

(d) Genuine nature test

3.031 Besides the fulfilment of the subjective and objective tests, it can be derived from the wording of Article 1(2) PSD that the transaction or series of transactions must not be genuine, having regard to all relevant facts and circumstances. According to Article 1(3) PSD, a transaction or series of transactions is not genuine if it is not put into place for valid commercial reasons which reflect economic reality. The relevance and scope of this genuine nature test are debated. Debelva and Luts wonder whether this test has any added value.[68] Marres and de Groot are of the opinion that the phrase "put into place for valid commercial reasons" is meant to indicate that there must be commercial reasons for setting up the arrangement, which would not be the case if the arrangement was set up for other tax reasons than obtaining the benefits of the PSD (e.g. a tax system that is generally favourable for setting up companies

65 Case C-6/16 Eqiom and Enka [2017] ECLI:EU:C:2017:641, para 20. See, for example, also Case C-448/15 Wereldhave Belgium and Others [2017] ECLI:EU:C:2017:354, para 25 and Danish PSD Cases, para 112.

66 Note that since the 2014 amendment and the 2015 amendment of the PSD, the purpose is also (i) to avoid double non-taxation resulting from the combined effect of the exemption of the profit distributions in the Member State where the parent entity is established and the deductibility from the tax base of the same profit distributions at the level of the subsidiary in the Member State where the subsidiary is established and (ii) to deny the benefits in abusive situations.

67 Weber, 'The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive' 113.

68 Debelva and Luts, 'The General Anti-Abuse Rule of the Parent-Subsidiary Directive' 227.

such as holding companies or finance companies).[69] Weber argues that the genuine nature test forms part of the subjective test and wonders why the term "not genuine" is used and not the term "artificial".[70] He is of the opinion that the interpretation of both terms is the same.[71] De la Feria finds the inclusion of the genuine nature test problematic and argues that it would have been preferable to define artificiality solely with reference to the main purpose or one of the main purposes.[72] De Broe and Beckers are of the opinion that, if the subjective test and objective test are applied correctly, the genuine nature test has little relevance.[73] It will be up to the CJEU to reconcile the wording of the genuine nature test in the PSD GAAR with its two-prong abuse test, which does not include an explicit genuine nature test. It can be derived from the decision in Nordcurrent UAB[74] that CJEU does not see the genuine nature test as a separate third condition of the PSD GAAR.[75]

(e) Consequences

If an arrangement or series of arrangements is regarded as abusive, the benefits of the PSD shall not be granted. The benefits of the Directive include both the exemption of withholding tax in the state of the subsidiary (Article 5 PSD) and relief from double taxation in the state of the parent entity by means of exemption of the distributed profits received or the grant of a tax credit for the taxes paid at the level of the subsidiary (Article 4 PSD). The author agrees with Marres and de Groot that this does not necessarily mean that in cases of abuse automatically the benefits of both Article 4 and 5 PSD must be denied, and that it must be assessed which tax advantage the taxpayer aimed to obtain **3.032**

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69 Marres and Groot, 'The General Anti-Abuse Clause in the EU Parent-Subsidiary Directive'; see also Marres, 'The Parent-Subsidiary Directive' sec. 16.8.5.

70 Similarly, De Broe and Beckers, 'The General Anti-Abuse Rule of the Anti-Tax Avoidance Directive' 143.

71 Weber, 'The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive' 114. See also Marres and de Groot, who cannot see any difference between the two terms. Marres and Groot, 'The General Anti-Abuse Clause in the EU Parent-Subsidiary Directive'.

72 de la Feria, 'EU General Anti-(Tax) Avoidance Mechanisms' 22.

73 De Broe and Beckers, 'The General Anti-Abuse Rule of the Anti-Tax Avoidance Directive' 143.

74 Para. 45: "Second, the arrangement must have been put into place with *the main purpose or one of its main purposes* being that of obtaining a tax advantage that defeats the object of that directive." Para. 46: "Therefore, it is not sufficient to establish that the arrangement was not put into place for valid commercial reasons reflecting economic reality, which corresponds to the definition of a non-genuine arrangement set out in Article 1(3) of Directive 2011/96. It is also necessary, in accordance with Article 1(2) of that directive, for the arrangement to have been put into place *with the main purpose* of obtaining a tax advantage that defeats the object or purpose of that directive" (emphasis added).

75 Para. 45:

> "In the light of the wording of the anti-abuse provision set out in Article 1(2) and (3) of Directive 2011/96, *two conditions* must be satisfied in order for the benefits of that directive to be denied" (emphasis added).

that defeated the object and purpose of the PSD.[76] It is convincingly argued in literature that the denial of benefits includes the denial of favourable tax treatment under a potentially applicable tax treaty.[77]

D. THE RELATION BETWEEN THE GENERAL PRINCIPLE OF PROHIBITION OF ABUSE OF EU LAW AND THE PSD GAAR

1. Overview

3.033 The question arises as to what the relation is between the general principle of prohibition of abuse of EU law as developed in the case law of the CJEU and the PSD GAAR, or more generally, what the relationship between this principle forming part of primary EU law and the anti-abuse provisions included in EU tax Directives is.[78] To answer this question, it must first be addressed if the scope of the general principle of prohibition of abuse is the same across the different fields of EU law. Different views exist in literature, and it is debated whether EU law encompasses multiple notions of tax abuse, with distinctions drawn between abuse of primary and secondary law, or whether a single, overarching anti-abuse principle exists, applying universally across tax law while producing varying outcomes depending on the context.[79] Although the author wonders whether the discussion has much practical relevance,[80] the author agrees with the position of other scholars such as De la Feria, English and De Broe that based on the case law of the CJEU it can convincingly be argued that there is only one overarching anti-abuse principle of which the exact scope depends on, among other things, the facts of the case and the object and purpose of the law that is allegedly abused.[81] Hence, the scope of the anti-abuse

76 Marres and Groot, 'The General Anti-Abuse Clause in the EU Parent-Subsidiary Directive' 10.5.2.

77 One of the arguments is that if the PSD GAAR requires the denial of the benefits because a certain arrangement or series of arrangements is regarded as abusive for the purposes of the PSD, it would violate EU law to grant similar benefits under a tax treaty. Weber, 'The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive' 127–28; Marres and Groot, 'The General Anti-Abuse Clause in the EU Parent-Subsidiary Directive' 243. Marres, 'The Parent-Subsidiary Directive' sec. 16.8.6. Contra Debelva and Luts, 'The General Anti-Abuse Rule of the Parent-Subsidiary Directive' 231.

78 Anti-abuse provisions are besides in the PSD also included in the IRD, Merger Directive and ATAD.

79 For a general discussion, see De Broe, 'Tax Abuse in the European Union'.

80 There is general agreement in the literature that it can be derived from the case law of the CJEU that the principle of prohibition of abuse does not have the exact same scope or the same application across all fields of EU law. Saying that there is one overarching principle of prohibition of abuse of which the intensity varies depending on the area of law at stake or saying that there are multiple notions of abuse with a different scope or different application depending on the area of law at stake, can in practice lead to the same outcome.

81 De Broe, 'Tax Abuse in the European Union' 5–9; de la Feria, 'EU General Anti-(Tax) Avoidance Mechanisms' 1–2.

principle when applied in light of the freedom of establishment is not necessarily the same as when applied in light of the PSD.[82]

What is now the relation between the general principle of prohibition of abuse of EU law as developed in the case law of the CJEU and the PSD GAAR? First, the confirmation of the existence of the general principle and that it follows from this principle that Member States are obliged to deny the benefits of the PSD in abusive cases[83] reduces the relevance of the PSD GAAR.[84] Indeed, one of the reasons to adopt the PSD GAAR was to oblige Member States to have a GAAR in place that is at least as strict as the PSD GAAR de minimis rule, but since the CJEU stated in the Danish Cases that such an obligation already follows from the general principle of prohibition of abuse of EU law, the PSD GAAR becomes less relevant in that regard. **3.034**

Second, it concerns two different instruments, the interpretation of which in cases of alleged abuse of the PSD has to be reconciled. As pointed out in Section C, important differences exist between the wording of the PSD GAAR and the general principle of the prohibition of abuse of EU law as developed by the CJEU in its case law, in particular regarding the subjective test and the genuine nature test. Since the PSD GAAR codifies the general principle that any abuse of rights is prohibited and that principle is regarded as forming part of primary EU law, the PSD GAAR has to be interpreted and applied in light of this principle. It will be a burdensome task for the CJEU[85] to reconcile the two instruments whereby the CJEU will have to consider the wording of the PSD GAAR, which might impact the interpretation of the **3.035**

82 L. De Broe, 'Some thoughts about the case law of the CJEU and Belgian courts on the application of anti-abuse measures under the Parent/Subsidiary and Interest/Royalty Directive' in: I. Richelle, W. Schön and E. Traversa (eds), *Abuse of Law in EU Law* (Springer 2025) [forthcoming].

83 Danish PSD Cases, para 72: "It thus follows from that principle that a Member State <u>must</u> refuse to grant the benefit of the provisions of EU law where they are relied upon not with a view to achieving the objectives of those provisions but with the aim of benefiting from an advantage in EU law although the conditions for benefiting from that advantage are fulfilled only formally" (emphasis added).

84 According to Tenore, the relevance of the PSD GAAR ends up, as a consequence of the CJEU judgment in the Danish PSD Cases, being very limited. Mario Tenore, 'The Parent-Subsidiary Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde Verlag 2024), 157. Marres is of the opinion that relevance of the PSD GAAR is significantly reduced by the Danish PSD Cases. Marres, 'The Parent-Subsidiary Directive' sec. 16.8.1. According to De Broe it follows from the Danish Cases that the PSD GAAR has become redundant "because the prohibition to abuse EU law qualifies as a general principle of EU law that should be applied by Member States, even in the absence of adequate anti-avoidance measures in domestic law". De Broe, 'Tax Abuse in the European Union' sec. 3.1.

85 In this regard, the author is more cautious than the author of Marres, 'The Parent-Subsidiary Directive' 520. There it is written that "We expect the Court *to take little notice* of the differences between the various general anti-abuse provisions in the corporate tax Directives, and to apply them all in the same restrictive manner in which it also applies its general 'abuse of rights' doctrine" (emphasis added).

general principle that any abuse of rights is prohibited in situations addressing alleged abuse of the PSD.[86]

3.036 In its decision in Nordcurrent UAB, the CJEU confirmed that the case law on the general principle of the prohibition of abuse relating to PSD is relevant for the interpretation of the PSD GAAR. In this decision, the CJEU referred on several occasions to its decision in the Danish PSD Cases, but the analysis mainly centralised around the interpretation of the PSD GAAR.

2. Abuse of the PSD in the case law of the CJEU

(a) General

3.037 In the cases Eqiom,[87] Deister and Juhler,[88] and the Danish PSD Cases,[89] the CJEU had the opportunity to rule on abuse of the PSD. All these cases deal with situations whereby the tax authorities of the Member State where the entity making the profit distribution was located refused to grant the exemption of withholding tax provided for by Article 5(1) PSD. Whereas Eqiom, and Deister and Juhler dealt with domestic anti-abuse rules and the application of old Article 1(2) PSD (now Article 1(4) PSD),[90] the Danish PSD Cases addressed how the principle that any abuse of rights is prohibited applies to situations involving the PSD. What follows is a summary of the facts of these cases together with their influence on the interpretation of the PSD GAAR.

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86 Note that in this regard, among others the question arises if the PSD GAAR provides for an exhaustive harmonization and whether any national measure implementing the PSD GAAR should solely be assessed in the light of the text of the PSD GAAR or in the light of the general principle of the prohibition of abuse of EU law. For a discussion on exhaustive harmonization on the ATAD GAAR and Article 1(4) PSD (old Article 1(2) PSD) see respectively De Broe and Beckers, 'The General Anti-Abuse Rule of the Anti-Tax Avoidance Directive' 142 and CFE ECJ Task Force, 'Opinion Statement ECJ-TF 2/2018 on the ECJ Decision of 7 September 2017 in Eqiom (Case C-6/16), Concerning the Compatibility of the French Anti-Abuse Rule Regarding Outbound Dividends with the EU Parent-Subsidiary Directive (2011/96) and the Fundamental Freedoms' (2018) European Taxation, issue 10, 472–74.

87 Case C-6/16 Eqiom and Enka [2017] ECLI:EU:C:2017:641.

88 Joined Cases C-504/16 and C-613/16 Deister Holding AG and Juhler Holding A/S v Bundeszentralamt für Steuern [2017] ECLI:EU:C:2017:1009.

89 See footnote 5.

90 *Eqiom and Enka* and *Deister Holding and Juhler Holding* are often discussed together in academic literature. See, for example, C. Brokelind, 'Anti-Directive Shopping on Outbound Dividends in Light of the Pending Decision in Holcim France (Case C-6/16)' (2016) European Taxation 56, issue 9, 394; CFE ECJ Task Force, 'Opinion Statement ECJ-TF 2/2018 on the ECJ Decision of 7 September 2017 in Eqiom (Case C-6/16)'; L. Aarup et al., 'When Are Domestic Anti-Avoidance Rules in Breach of Primary and Secondary EU Law? - Comments Based on Recent ECJ Decisions' (2018) European Taxation, issue 4, 130–39; B. Kuźniacki, 'The ECJ as a Protector of Tax Optimization via Holding Companies' (2019) Intertax, issue 3, 312–323.

(b) Old Article 1(2) PSD and Domestic anti-abuse rules: Eqiom and Deister and Juhler

Eqiom was a company established in France and a subsidiary of Enka, a company governed by Luxembourg law. Enka was wholly controlled by a Cypriot company which, in turn, was held by a Swiss company. In 2005 and 2006, dividends were paid by Eqiom to Enka. The French tax code had rules in place similar to Article 5(1) PSD and it was not disputed that the dividend distribution fell within the scope of the PSD. However, the French tax authorities denied the exemption of withholding tax because according to the French legislation applicable at the time, the exemption of WHT shall not be granted if the distributed dividends are received by a legal person controlled directly or indirectly by one or more residents of states that are not members of the EU, unless that legal person provides proof that the principal purpose or one of the principal purposes of the chain of interests is not to take advantage of the exemption (hereinafter referred to as the French anti-abuse rule). **3.038**

The case came before the French courts and ended up before the CJEU. The CJEU assessed first whether the old Article 1(2) PSD (now Article 1(4) PSD) precluded the application of the French anti-abuse rule.[91] The CJEU ruled that although old Article 1(2) of the PSD provides that the PSD does not preclude the application of domestic or agreement-based provisions required for the prevention of fraud and abuse, that provision reflects the general principle of EU law that no one may benefit from the rights stemming from the legal system of the European Union for abusive or fraudulent ends and hence must be interpreted strictly.[92] The CJEU furthermore noted that in order for national legislation to be regarded as seeking to prevent tax evasion and abuses, its specific objective must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, the purpose of which is unduly to obtain a tax advantage.[93] **3.039**

In this regard, a general presumption of fraud and abuse cannot justify a fiscal measure which compromises the objectives of a directive or a fiscal measure which prejudices the enjoyment of a fundamental freedom guaranteed by the Treaties.[94] Member States cannot apply predetermined general criteria in order to determine whether an operation pursues an objective of fraud and abuse, **3.040**

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91 The CJEU also ruled on whether the application of the French anti-abuse rule is precluded under the fundamental freedoms, which will not be further discussed here given the scope of this contribution.

92 Case C-6/16 Eqiom and Enka [2017] ECLI:EU:C:2017:641, paras 25–26.

93 Case C-6/16 Eqiom and Enka [2017] ECLI:EU:C:2017:641, para 30.

94 Case C-6/16 Eqiom and Enka [2017] ECLI:EU:C:2017:641, para 31.

but a case-by-case analysis is required.[95] The CJEU noted that the French anti-abuse rule is not specifically designed to exclude from the benefit of a tax advantage purely artificial arrangements designed to unduly benefit from that advantage, but covers, in general, any situation where a company directly or indirectly controlled by residents of third states has its registered office, for any reason whatsoever, outside France[96] The CJEU concluded that it must be held that Article 1(2) of the Parent-Subsidiary Directive must be interpreted as precluding the French anti-abuse rule.

3.041 Deister and Juhler were two different cases that were decided together. Deister Holding[97] was a company with its registered office in the Netherlands. Deister Holding had several participations in companies established in different states, including a participation in a company established in Germany. Deister Holding rented an office in the Netherlands and had two employees. The sole shareholder of Deister Holding was an individual resident in Germany. The aforementioned German subsidiary paid dividends to Deister Holding for which an exemption of WHT was claimed. The German tax authorities refused this request.

3.042 Juhler Holding was a company with its registered office in Denmark. It was held by a company incorporated under Cypriot law, which in turn was solely held by an individual resident in Singapore. Juhler Holding held participations in more than 25 companies, including a 100% participation in a German company. Juhler Holding exercised financial control within the group to optimise the group's interest costs and was responsible for supervising the performance of the subsidiaries. Juhler Holding had a phone line and an email address but did not have its own offices. It used the premises and staff of other companies in which it held participations and its chief executive was also on the boards of various companies in the group. Juhler Holding received a dividend from its aforementioned 100% German subsidiary. Also, in this case, an exemption of WHT was claimed but was refused by the German tax authorities. Under the German legislation applicable at the time, a foreign company was not entitled to an exemption if its shareholders would not have been entitled to the refund or exemption if they had earned the income directly, and

(1) there were no economic or other substantial reasons for the involvement of the foreign company or

95 Case C-6/16 Eqiom and Enka [2017] ECLI:EU:C:2017:641, para 32.
96 Case C-6/16 Eqiom and Enka [2017] ECLI:EU:C:2017:641, para 33.
97 Formerly Traxx Investments.

(2) the foreign company did not earn more than 10% of its entire gross income for the financial year in question from its own economic activity or
(3) the foreign company did not take part in general economic commerce with a business establishment suitably equipped for its business purpose.[98] (hereinafter the German anti-abuse rule)

The three additional conditions were not cumulative (i.e., it was sufficient that one was fulfilled to deny the exemption) and were unconditional without a possibility for a rebuttal.[99] The CJEU decided that no opinion of the Advocate General was needed to render a ruling and in its decision the CJEU referred extensively to its decision in Eqiom. The CJEU repeated some of its statements in Eqiom and added that measures taken by the Member States for the prevention of fraud and abuse must be appropriate for attaining that objective and must not go beyond what is necessary to attain it.[100] The CJEU concluded that Article 1(2) in conjunction with Article 5(1) PSD must be interpreted as precluding the German anti-abuse rule among others because the rule was not specifically designed to address wholly artificial arrangements but instead covers any situation in which persons who would not have been entitled to such an exemption if they received the dividends directly have holdings in a non-resident parent company.[101] In addition, by subjecting the grant of the exemption to the additional requirement that none of the three aforementioned conditions of the German anti-abuse rule were fulfilled without the tax authorities being required to provide prima facie evidence of the absence of economic reasons or of fraud or abuse, the legislation introduced a general presumption of fraud or abuse thereby not allowing a non-resident parent company to provide evidence demonstrating the existence of economic reasons (thus creating an irrebuttable presumption of fraud or abuse).[102] Interestingly, the CJEU added that the PSD does not contain any requirement as to the nature of the economic activity of the companies falling within the scope of the PSD or the amount of turnover resulting from those companies' own economic activity.[103] The CJEU furthermore explained that the fact that the economic activity of a non-resident parent company consists in the management of its subsidiaries' assets, 3.043

98 The referring court noted that the active management of a leasing, letting, investment, financing or holding company would, in the case of a non-resident parent company, not be regarded as amounting to its own economic activity within the meaning of this provision. Joined Cases C-504/16 and C-613/16 Deister Holding AG and Juhler Holding A/S v Bundeszentralamt für Steuern [2017] ECLI:EU:C:2017:1009, para 29.

99 Deister Holding and Juhler Holding, para 30.

100 Deister Holding and Juhler Holding, para 56.

101 Deister Holding and Juhler Holding, para 64.

102 Deister Holding and Juhler Holding, paras 69-70

103 Deister Holding and Juhler Holding, para 72.

or that the income of that company resulted solely from such management, could not, per se, indicate the existence of a wholly artificial arrangement that did not reflect economic reality. In this regard, the fact that the management of assets was not considered to constitute an economic activity for the purposes of VAT was irrelevant given the different purpose of the VAT rules.[104]

3.044 It can be concluded that in these cases, the CJEU set clear boundaries on the possibility for Member States to introduce domestic anti-abuse rules based on Article 1(4) PSD. Such rules must be proportional, taking into account the object and purpose of the PSD and must respect the fundamental freedoms. They must be designed to address purely artificial arrangements, must not create general irrebuttable presumptions of fraud and abuse, and the taxpayer who is denied the benefits of the PSD must be granted the possibility to provide evidence demonstrating the existence of economic reasons.

(c) The general principle of prohibition of abuse of EU law and the PSD: the Danish PSD Cases

3.045 The Danish PSD Cases dealt with dividend distributions by Danish companies, whereby an exemption of WHT was claimed, provided for by the PSD, but whereby the Danish tax authorities refused to grant the exemption.[105] The Danish Cases concerned two different factual patterns, which can be summarised as follows. In the case, T Danmark private equity funds established in third countries set up companies in Luxembourg to acquire a holding in a Danish company. The case of Y Denmark involved a chain of companies, whereby a US company has a subsidiary established in Bermuda, which on its turn had a subsidiary established in Cyprus. The subsidiary established in Cyprus held a participation in a Danish company. The facts of two cases have in common that dividend distributions were made from Denmark to a company established in an EU Member State, but which was held by a company established in a third state. According to the Danish tax authorities, the companies established in other EU Member States were conduit companies interposed in the structure to channel profits of the Danish companies

104 Deister Holding and Juhler Holding, paras 73-74.

105 The Danish PSD Cases have been intensively discussed in the literature. See, for example, A. Zalasiński, 'The ECJ's Decisions in the Danish 'Beneficial Ownership' Cases: Impact on the Reaction to Tax Avoidance in the European Union' (2019) International Tax Studies, issue 4; S. Baerentzen, 'Danish Cases on the Use of Holding Companies for Cross-Border Dividends and Interest – A New Test to Disentangle Abuse from Real Economic Activity?' (2020) World Tax Journal, issue 1, 3; J. Englisch, 'The Danish Tax Avoidance Cases: New Milestones in the Court's Anti-Abuse Doctrine' (2020) Common Market Law Review, issue 2, 503–37; L. De Broe et al., 'Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases' (2019) EC Tax Review, issue 6, 270–99.

to companies established in third countries without having to pay WHT (i.e. cases of directive shopping). For this reason, the Danish tax authorities denied the exemption of WHT. Three elements will be addressed here.

First. A key aspect in the Danish PSD Cases was that Denmark did not have a written general anti-abuse rule in place to deny the benefits of the PSD and the first issue addressed by the CJEU was whether this prevented Denmark from denying the exemption from WHT. The CJEU ruled that a general legal principle exists in EU law which states that EU law cannot be relied on for abusive or fraudulent ends[106] and that it follows from that principle "that a Member State must refuse to grant the benefit of the provisions of EU law where they are relied upon not with a view to achieving the objectives of those provisions but with the aim of benefiting from an advantage in EU law although the conditions for benefiting from that advantage are fulfilled only formally."[107] In a later paragraph, the CJEU added that "in the light of the general principle of EU law that abusive practices are prohibited and of the need to ensure observance of that principle when EU law is implemented, the absence of domestic or agreement-based anti-abuse provisions does not affect the national authorities' obligation to refuse to grant entitlement to rights provided for by Directive 90/435 where they are invoked for fraudulent or abusive ends."[108] The decision of the CJEU in the Danish PSD Cases entails that Member States have an obligation to address abuse of the PSD, makes Article 1(4) PSD (old Article 1(2) PSD) redundant in the sense that the reservation contained in said Article for Member States not to implement measures preventing abuse becomes, turns out to be meaningless.[109] **3.046**

Second. The CJEU provided indicators of abuse which can result in the denial of the WHT exemption of the PSD. The CJEU first explained that an examination of the facts is needed to establish whether the constituent elements of an abusive practice are present (i.e. the objective and subjective elements), and whether the contested transactions are purely formal or artificial devoid of any economic and commercial justification and with the essential aim of benefiting from an improper advantage.[110] The CJEU further clarified that a group of companies may be regarded as an artificial arrangement if it is not set up for **3.047**

106 Danish PSD Cases, para 70.
107 Danish PSD Cases, para 72.
108 Danish PSD Cases, para 83.
109 This position of the CJEU is subject to criticism. See, for example, Schön, 'The Concept of Abuse of Law in European Taxation'; De Broe et al., 'Danish Dynamite' 276–80.
110 Danish PSD Cases, para 98.

reasons that reflect economic reality, its structure is purely one of form and its principal objective or one of its principal objectives is to obtain a tax advantage running counter to the aim or purpose of the applicable tax law.[111] Next, the CJEU provided five situations that can give an indication of the existence of an abusive arrangement[112]:

1) (Almost) all the dividends are, very soon after their receipt, passed on by the company that has received them to entities which do not fulfil the conditions for the application of PSD[113];
2) The group is structured in such a way that the company which receives the dividends must itself pass those dividends on to a third company which does not fulfil the conditions for the application of the PSD and consequently the interposed company makes only an insignificant taxable profit[114];
3) It follows from an analysis of all the relevant factors, such as the management of the company, its balance sheet, its structure of its costs and the expenditure actually incurred, the staff that it employs and the premises and equipment that the interposed company lacks an actual economic activity and that it has as its sole activity the receipt of dividends and their transmission to the beneficial owner or to other conduit companies[115];
4) It follows from the various contracts existing between the companies involved in the financial transactions at issue, from the way in which the transactions are financed, by the valuation of the intermediary companies' equity and by the inability to have economic use of the dividends received that the transaction concerns an artificial arrangement. In this regard, one should not only take into account any legal obligation of the parent company receiving the dividends to pass them on to a third party, but also the fact that, "in substance" that a company, without being bound by such a contractual or legal obligation, does not have the right to use and enjoy those dividends[116];
5) The aforementioned indicators might be reinforced if complex financial transactions are set up and intragroup loans are granted just before or after the entry into force of major new tax legislation.

3.048 Although these indicators certainly have their relevance, they are only indicators that do not lead to legal certainty and still raise many questions (e.g. what is the weight of the different indicators, how many of them need to be met, . . .).

111 Danish PSD Cases, para 100.
112 For a discussion of these indicators, see also De Broe et al., 'Danish Dynamite' 282–86.
113 Danish PSD Cases, para 101.
114 Danish PSD Cases, para 103.
115 Danish PSD Cases, para 104.
116 Danish PSD Cases, para 105.

Third. In its judgment, the CJEU also provided guidance on the burden of proof related to the PSD.[117] It is the responsibility of taxpayers who claim the benefits of the PSD to demonstrate that they meet the formal conditions laid down in the PSD.[118] However, it is up to the tax authorities which seek to deny the benefits of the PSD to establish the existence of the elements constituting an abusive practice, thereby taking into account all relevant factors.[119] **3.049**

(d) Nordcurrent UAB

Nordcurrent UAB is the first case that specifically dealt with the interpretation of the PSD GAAR. The facts and some of its consequences regarding the application of the PSD GAAR have already been described in Section C.2.b and will consequently not be further discussed here. **3.050**

E. ARTICLE 1(4)

Article 1(4) PSD (old Article 1(2)) safeguards the right to apply domestic or agreement-based provisions required for the prevention of fraud or abuse. It was already pointed out under Section A that the CJEU ruled with respect to the initial wording of Article 1(2) PSD that reflects the general principle of EU law that any abuse of rights is prohibited, and in Section D.2.c that the decision of the CJEU in the Danish PSD Cases that Member States have an obligation to address abuse of the PSD, makes Article 1(4) PSD (old Article 1(2) PSD) redundant in the sense that the reservation contained in said Article for Member States not to implement measures preventing abuse turns out to be meaningless. For these reasons, among others, the author agrees with other authors that Article 1(4) PSD has little value, if any value at all.[120] **3.051**

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117 Although in the Danish Cases the CJEU as such only ruled explicitly on the burden of proof in cases where the source state wishes to deny the exemption of WHT, the same is according to the author also true for the benefits available under Article 4 PSD in the Member State where the company receiving the profit distribution is established. For a discussion on the burden of proof see, for example, De Broe et al., 'Danish Dynamite' 286; Zalasiński, 'The ECJ's Decisions in the Danish 'Beneficial Ownership' Cases' sec. 4.6.

118 Danish PSD Cases, para 116.

119 Danish PSD Cases, para 117.

120 See, for example, Marres, 'The Parent-Subsidiary Directive' sec. 16.8.7.

4

ARTICLE 2–3: PERSONAL SCOPE OF APPLICATION OF THE DIRECTIVE

Jasper Korving

ARTICLE 2

For the purposes of this Directive the following definitions shall apply:

(a) **'company of a Member State' means any company which:**
  - (i) **takes one of the forms listed in Annex I, Part A;**
  - (ii) **according to the tax laws of a Member State is considered to be resident in that Member State for tax purposes and, under the terms of a double taxation agreement concluded with a third State, is not considered to be resident for tax purposes outside the Union;**
  - (iii) **moreover, is subject to one of the taxes listed in Annex I, Part B, without the possibility of an option or of being exempt, or to any other tax which may be substituted for any of those taxes;**

  (b) **'permanent establishment' means a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on in so far as the profits of that place of business are subject to tax in the Member State in which it is situated by virtue of the relevant bilateral tax treaty or, in the absence of such a treaty, by virtue of national law.**

ARTICLE 3

1. **For the purposes of applying this Directive:**
  - (a) **the status of parent company shall be attributed:**
    - (i) **at least to a company of a Member State which fulfils the conditions set out in Article 2 and has a minimum holding of 10 % in the capital of a company of another Member State fulfilling the same conditions;**
    - (ii) **under the same conditions, to a company of a Member State which has a minimum holding of 10 % in the capital of a company of the**

same Member State, held in whole or in part by a permanent establishment of the former company situated in another Member State;

(b) **'subsidiary' means that company the capital of which includes the holding referred to in point (a).**

2. **By way of derogation from paragraph 1, Member States shall have the option of:**
   (a) **replacing, by means of bilateral agreement, the criterion of a holding in the capital by that of a holding of voting rights;**
   (b) **not applying this Directive to companies of that Member State, which do not maintain for an uninterrupted period of at least 2 years holdings qualifying them as parent companies, or to those of their companies in which a company of another Member State does not maintain such a holding for an uninterrupted period of at least 2 years.**

COMMENTARY

A. INTRODUCTION

Articles 2 and 3 of the Parent-Subsidiary Directive determine the personal scope of application of the directive. Member States are obliged to grant the benefits of the directive to situations meeting the material criteria of Article 1 and the personal criteria of the Articles 2 and 3. These qualify, however, only as minimum harmonisation. Upon implementation of the requirements into domestic law, Member States can opt to apply, for instance, lower thresholds or extend the qualifying legal forms as included in the Annex to the Parent-Subsidiary Directive. 4.001

4.002 In this chapter, I will discuss the different elements of Articles 2 and 3 of the Parent-Subsidiary Directive. I will start by giving a broad overview of the historic context of the coming into being of both articles (Section B), before going into more detail into both articles (Sections C and D). Besides discussing the constitutive elements of both provisions, the articles are also placed in a historic context and case law by the CJEU is taken into account. The relationship between certain elements and primary EU law will also be addressed. I will end this chapter with a brief conclusion (Section E).

B. BRIEF HISTORY OF ARTICLES 2 AND 3 OF THE PARENT-SUBSIDIARY DIRECTIVE

4.003 Originally, direct tax harmonisation was not at the EU's political centre of attention.[1] In its 1963 Neumark report, the European Commission indicated that the unification of the corporate income tax system within the – currently – EU[2] was not a main objective, also indicating that unification does not equal harmonisation.[3]

4.004 A few years later, in 1967, the European Commission tried to concretise its future efforts for the harmonisation of direct taxes in its tax harmonisation programme.[4] The European Commission drew up a more concrete harmonisation programme wishing to amplify and fill in more detail in the documents drafted during non-specified 'recent exchange of views on tax harmonization'.[5] Harmonisation needed to be limited to what was necessary for the establishment or smooth functioning of the common market.[6] The programme split actions to be taken before and after 1 July 1968, that is, the date when the

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1 For a historic overview, see J. Chown and W. Hopper, 'Company Tax Harmonisation in the European Economic Community' (1982) Intertax, issue 8, 275. Also see P. Baert, 'Briefing on BEFIT – Business in Europe: Framework for income taxation', PE 754.631 of December 2023, https://www.europarl.europa.eu/RegData/etudes/BRIE/2023/754631/EPRS_BRI(2023)754631_EN.pdf (accessed 1 March 2024). Also see S. Blaakman and J. Korving, 'The tax base in BEFIT and Pillar Two: Harmony, dissonance or off-key?' (2024) Intertax, issue 5, 362, paragraph 2.1.1.

2 The author will refer to the EU throughout this article, even though he acknowledges that the successive European Economic Community, European Community, and European Union might have had slightly different perspectives and rules. As these are of a minor importance for this publication, the author only refers to the current name of the European Union.

3 Neumark report, https://koflerge.files.wordpress.com/2019/01/neumark.pdf (1 March 2024).

4 Supplement to European Economic Community Bulletin No. 8-1967 of the European Economic Community.

5 Supplement to European Economic Community Bulletin No. 8-1967 of the European Economic Community, 3.

6 Now: internal market.

last customs barriers between the six Member States would disappear and the common agricultural market would have been fully established.

In relation to direct taxes, the tax harmonisation programme indicated that, before 1 July 1968, certain actions were required due to the gradual liberalisation of capital movements. In that respect, the European Commission's aim was the complete elimination of international double taxation of dividends and interest and, in general, the removal of all the factors – distortions or discriminatory practices – likely to engender abnormal capital movements, to maintain market segregation and to curb the expansion of savings.[7] In order to achieve that objective, five measures were required:[8] **4.005**

1. The creation of a harmonised withholding tax system on interest on negotiable bonds and on dividends;
2. The adjustment in Belgium and France of certain procedures for the application of tax credits that are of a discriminatory nature;[9]
3. The establishment of a single method for relieving the total tax burden on distributed dividends (tax relief for the company or for the shareholder);
4. The adjustment and harmonisation of the tax implications of the operations of investment companies (including unit trusts) with a view to eliminating any tax discrimination against investments through such companies or trusts as compared with direct investment;[10] and
5. The harmonisation of the tax arrangements applicable to holding companies and the amendment of certain regulations.

Subsequently, and more extensively, the European Commission indicated that double taxation is a major obstacle to the free movement of capital.[11] Even though in the long run, the aim was to create fiscal neutrality,[12] other practical solutions had to be found to solve issues in the shorter term. To that end, the European Commission suggested:[13] **4.006**

a) a system of withholding tax charged on dividends and interest;

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7 Supplement to European Economic Community Bulletin No. 8-1967 of the European Economic Community, 4.

8 Ibid.

9 Also see Supplement to European Economic Community Bulletin No. 8-1967 of the European Economic Community, 13-14.

10 Also see Supplement to European Economic Community Bulletin No. 8-1967 of the European Economic Community, 14.

11 Supplement to European Economic Community Bulletin No. 8-1967 of the European Economic Community, 9.

12 J. Korving, *Internal Market Neutrality* (Sdu 2019).

13 Supplement to European Economic Community Bulletin No. 8-1967 of the European Economic Community, p. 10.

b) methods of reducing the economic double taxation of dividends;
c) resolving discrepancies in the tax arrangements applicable to holding companies;[14] and
d) tax treatment of income from investments handled by financial intermediaries, particularly by the various types of investment companies.

4.007 The European Commission continues by extensively explaining the reason for a harmonised approach for a withholding tax on dividends and interest, even though the mere focus appears to be on withholding taxes as a prelevy to personal income tax.[15] Harmonisation would, for instance, speed up the flow of revenue and it would cut back the loss of receipts due to tax fraud.[16] Besides that, the European Commission remarks that double tax conventions between the different Member States do not solve all issues. Sometimes bilateral treaties do not exist, sometimes existing treaties do not foresee in all necessary avoidances of double taxation.[17] Furthermore, administrative requirements can make existing methods complex.[18] The proposal for harmonisation mainly required the qualification of a withholding tax as a prelevy to personal income tax, meaning that the withholding tax should be credited or reimbursed in full against the personal income tax liability of the taxpayer.[19] Besides that, a common withholding tax rate of 25% should be introduced for dividend payments within the EU.

4.008 Even though these proposals for actions to come to harmonisation in the field of dividend withholding taxes did not result in specific legislative proposals, the considerations on harmonisation had started. In 1969, the European Commission proposed the first version of the Parent-Subsidiary Directive.[20] The original proposal already included the starting point that distributed

14 The document remains unclear on which discrepancies are referred to. The tax treatment of dividends received by Belgium (tax credit) and France (reimbursement) is addressed, but that appears to relate to the avoidance of economic double taxation issues, as already addressed under letter b.

15 In the end, the remarks made may get closer to what, now finally, has been harmonised under the Faster and Safer Tax Relief of Excess Withholding Taxes (FASTER) Directive (Council Directive (EU) 2025/50 of 10 December 2024 on faster and safer relief of excess withholding taxes OJ L 2025/50.

16 Supplement to European Economic Community Bulletin No. 8-1967 of the European Economic Community, 10.

17 Supplement to European Economic Community Bulletin No. 8-1967 of the European Economic Community, 10-11.

18 Supplement to European Economic Community Bulletin No. 8-1967 of the European Economic Community, 11.

19 Supplement to European Economic Community Bulletin No. 8-1967 of the European Economic Community, 12.

20 Proposal for a Council directive on the common system of taxation applicable to parent companies and their subsidiaries of different Member States, COM(1969)6, OJ [1969] C39/7. The original proposal is only available in Dutch, French, German and Italian.

profits should be exempt from withholding tax and that profits received should, in principle, be exempt from corporate income tax.[21] The conditions for meeting the personal scope were less developed at that time. Originally, the European Commission acknowledged that the system that would eventually be introduced should be applied to 'important participations'. Even though the definition of such a participation varied among the Member States, the European Commission deemed it possible to introduce a compromise solution. An 'important participation' would consist of holding a minimum social capital of 20% that would not be alienated within two years after the shares were acquired. However, if Member States would prefer more liberal rules, the European Commission would not prohibit those.[22]

In 1970, for the first time, Article 2 required three main elements to qualify within the scope of the Parent-Subsidiary Directive. It was the start of the negotiations of the requirements that now still exist: a qualifying legal form as included in an Annex to the directive, being a tax resident of an EU Member State and being subject to a listed tax.[23] Even though negotiations continued after 1970, it would take until 1985 for the European Commission to come up with an amended proposal for the Parent-Subsidiary Directive or, more specifically, with a compromise text on Article 5 thereof in order to speed up the process.[24] All other elements would remain unamended. The Directive was adopted on 23 July 1990[25] and amended several times. The preamble to the 1990 Parent-Subsidiary Directive did not clarify any specific element of the material scope of the Directive. In 2011, the Parent-Subsidiary Directive was recasted.[26] The recasted directive has in the meantime been amended several times as well. Upon implementation, Member States cannot apply other conditions than the conditions specifically set in the directive.[27] **4.009**

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21 The original proposal did not yet make a distinction between a participation exemption system and a credit system. This was probably because the six Member States at that time all applied an exemption system. Later, after the accession of the United Kingdom, a credit system was added as a possible way to avoid double taxation at parent company level.

22 European Council, 1 August 1968, R/1497/68 (ECO174), 12. In the same document, the European Commission even suggests that for 'very important participations', that is, requiring a minimum shareholding of 50%, it should be made possible to enter into a cross-border consolidation regime where the included companies would be treated as if they were only a single taxpayer. This relates to Article 7 of the original proposal for the Parent-Subsidiary Directive.

23 European Council, 10 July 1970, R/1538/70 (ECO154), Annex, 2.

24 European Commission, 5 July 1985, COM(1985)360, OJ 1985 C

25 Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ [1990] L225/6.

26 Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast), OJ [2011] L345/8.

27 Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82.

C. ARTICLE 2 AND ITS CONSTITUTIVE ELEMENTS

1. Introduction

4.010 Article 2 of the Parent-Subsidiary Directive materialises what a 'company of a Member State' entails. It defines the concept based on three constitutive elements: the company should have a certain legal form (Section C.2), it should be a resident of a Member State (Section C.3) and it should be subject to a certain tax (Section C.4). All three constitutive elements will be elaborated on in the below.

4.011 It is important to note that the Parent-Subsidiary Directive does not require a company to meet all three requirements in the same EU Member State. Consequently, a dual resident entity, that is, a company that is incorporated under the laws of one EU Member State but is a tax resident and subject to tax in another EU Member State, still should be in the personal scope of the Parent-Subsidiary Directive. Such a company, thus, could benefit from the directive's withholding tax exemption and apply a prescribed method for the avoidance of double taxation.[28] Another position is possible, though, as the introductory part of Article 2 refers to the company[29] of a Member State in singular. That could imply that all three requirements should be met in one single Member State. I would not favour that interpretation. In all situations and after implementation, it should be determined by each individual Member State – that is, singularly – whether the three constitutive elements are met, and the wording of those elements does not explicitly refer to the elements all to be met by that individual Member State.

4.012 As indicated, the three constitutive criteria were first introduced in 1970. However, during the negotiation process, several suggestions for other criteria were made that, in the end, did not make it. During the negotiations regarding the 1969 proposal, France suggested to limit the scope of the Parent-Subsidiary Directive to companies that exercise their activities in the same economic sector.[30] Later, Italy joined France's initial view, while France itself

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28 Also see T. Kollruss, 'Dual resident companies and the implementation of the Parent-Subsidiary Directive by Germany in light of European Union secondary legislation and primary law: An analysis and review' (2012) EC Tax Review, issue 4, 183.

29 Also see T. Stevens, 'Taxation of hybrid entities under the Parent-Subsidiary Directive: The example of the Netherlands' (2011) EC Tax Review, issue 5, 242; R. Russo, 'Partnerships and other hybrid entities and the EC corporate direct tax Directives' (2006) European Taxation, issue 10, 478; G. Fibbe, The different translations of the term 'company' in the Merger Directive and the Parent-Subsidiary Directive: A Babylonian confusion of tongues? (2006) EC Tax Review, issue 2, 95.

30 European Council, 5 May 1969, R/673/69 (ECO92), 8

in the meantime was no longer in favour.[31] Italy voiced it wanted to restrict the application of the Parent-Subsidiary Directive to businesses in the same economic sector in order to stay within the objective of the directive, that referred to the concentration of companies within the EU.[32] The European Commission responded that defining the 'same economic sector' would be difficult and suggested that the 20% threshold that a parent company should hold in its subsidiary, as included in the original directive, should already constitute a comparable guarantee.[33] The other four Member States agreed with the European Commission.[34]

In addition, France wanted to limit the scope of the Parent-Subsidiary Directive to 'authentic European companies'. It defined the notion of 'authentic European company' as 'undertakings whose fundamental interests coincide permanently with those of the Community and which cannot benefit from the advantages reserved by their country of origin for EU permanent establishments of non-EU head offices. Such a coincidence of interests may be considered to exist where the undertaking is controlled by nationals or governments of Member States and its decision-making center is located in one of the EU Member States.'[35] This proposal did not make the final wording of the directive either. **4.013**

Apart from defining the constitutive elements of the 'company of a Member State', Article 2 of the Parent-Subsidiary Directive also defines the concept of 'permanent establishment' (Section 3.5). This definition was added in 2003. **4.014**

2. Legal form

The first requirement of being a 'company of a Member State' is that the company should take one of the forms listed in Annex I, Part A to the Parent-Subsidiary Directive. **4.015**

In the original proposal for the Parent-Subsidiary Directive, the scope of the directive concerned 'companies under the laws of the Member States that are subject to a listed tax'. The German delegation noticed that this could lead to different applications among the Member States, as in certain countries only capital companies would be subject to the listed forms of corporate income **4.016**

31 European Council, 25 September 1970, T/533/70 (ECO), 2.
32 European Council, 27 July 1970, R/1644/70 (ECO164), 8.
33 European Council, 5 May 1969, R/673/69 (ECO92), 8.
34 European Council, 27 July 1970, R/1644/70 (ECO164), 8.
35 European Council, 25 June 1970, R/1385/70 (ECO139), 2.

tax, while in others – like Belgium – also partnerships (i.e., 'personenvennootschappen') could be subject to corporate income tax. From that perspective, Germany suggested to limit the scope to 'capital companies'.[36] Later, it was suggested to explicitly refer to qualifying legal forms for each individual Member State in an Annex to the Parent-Subsidiary Directive.[37] At that time, the Member States still needed to decide on what to do with the potential listing of domestic forms of 'cooperative societies'.

4.017 Later, a desire existed among the Member States to cover a wider range of companies in the Parent-Subsidiary Directive. This was addressed in the proposal adopted in 1993.[38] That proposal aimed at extending the Directive to all enterprises resident and subject to corporation tax in a Member State. However, the asymmetries found in commercial law governing the legal types of entities and the diversity of tax arrangements applicable to them in the Member States created considerable problems. These difficulties were already brought up during the Council discussions on the proposal held during 1996 and 1997. These discussions were suspended without reaching a final conclusion. This subject has been discussed again with the Member States from a technical point of view in the framework of the appropriate Commission working party. As a result, the aim of improving the coverage of the Parent-Subsidiary Directive was achieved in the 2003 proposal by proposing the extension of the list of entities annexed to the Directive, to cover new named legal types.[39] In the end, however, the Member States stuck to the use of a list of qualifying legal forms instead of granting the Parent-Subsidiary Directive benefits in general to all companies resident and subject to tax in a Member State.

4.018 The current list, therefore, still includes qualifying companies on a per-country basis. Most EU Member States explicitly mentioned which specific legal forms incorporated under the laws of that state would be in scope. However, three EU Member States – Ireland, Lithuania and Portugal – took a more

36 European Council, 5 May 1969, R/673/69 (ECO92), 4. The European Parliament, by contrast, requested to specify that the proposed Parent-Subsidiary Directive referred to both capital companies and partnerships to qualify in scope of the directive; see European Council, 13 April 1970, 704/70 (ASS399), 2.

37 European Council, 10 July 1970, R/1538/70 (ECO154), 2.

38 Also see D. Schelpe, 'Two new proposals for a Directive amending the 'Merger' and 'Parent-Subsidiary' Directives' (1993) EC Tax Review 1993, issue 4, 200.

39 Explanatory Memorandum to the Proposal for a Council Directive amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, COM(2003)462 final, point 13.

flexible approach.[40] They included, differently phrased, all ‘companies incorporated under the law of’ their state as a description to the Annex.[41]

To some extent, this description could lead to legal uncertainty because it is not immediately clear whether a certain domestic legal form would be in scope of the Parent-Subsidiary Directive. Besides that, for taxpayers, it could be more burdensome, since they have to examine whether a certain local legal form is considered by either of the three Member States to be in scope of the directive. I doubt, though, whether this is actually problematic. **4.019**

To the contrary, the flexibility regarding the legal form criterion could also have solved other issues. In the CJEU *Gaz de France* case,[42] it concerned a dividend distribution by Gaz de France Deutschland GmbH to its 100% shareholder Gaz de France – Berliner Investissement SA in 1999. The shareholder had the legal form of a Société par Actions Simplifiée (SAS), a simplified form of the SA. Germany levied a withholding tax on the dividend distribution, since the French SAS was not included in the Annex to the Parent-Subsidiary Directive. The reason was that the Annex was created and adopted in 1990, while the SAS was only introduced in French law in 1994.[43] Besides that, the French listing of qualifying legal forms was close-ended, as it only referred to ‘companies under French law known as “société anonyme”, “société en commandite par actions”, “société à responsabilité limitée” and industrial and commercial public establishments and undertakings’. As the taxpayer did not agree with this static interpretation of the Annex, it appealed to the German tax **4.020**

40 Before the UK left the EU, this also applied to the UK.

41 In relation to the UK, this led to a discussion on whether companies incorporated under the law of Gibraltar also qualified as ‘companies under the law of the UK’ as required by the Annex to the Parent-Subsidiary Directive. The CJEU judged to the negative: ‘It should be noted that, in its written observations, the Government of the United Kingdom has stated that, under the domestic law of that Member State, companies incorporated under its national law can only be companies which are regarded as incorporated in the United Kingdom, and that these do not include companies incorporated in Gibraltar. This has not been formally disputed by the other parties to the proceedings before the Court.’ See Case C-458/18 GVC Services [2020] ECLI:EU:C:2020:266, points 38 and 40. As profit distributions to a Gibraltar incorporated company are not considered to be in scope of the Parent-Subsidiary Directive, another preliminary ruling request was directed to the CJEU in the same procedure in order to decide whether these situations are compatible with the freedom of establishment and the free movement of capital. In that decision, the CJEU confirmed that both fundamental freedoms could be applicable to Gibraltar, as the foreign relations for the territory were taken care of by an EU Member State and the scope of the freedoms were not restricted by the 1972 Accession Treaty. In the end, the CJEU confirmed that Bulgarian law is contrary to the freedom of establishment. See Case 287/23 Entain Services (Bulgaria) [2024] ECLI:EU:C:2024:418. On the relation between primary and secondary EU law, also see J. Korving, ‘The European Triangle: On the Relationship between Primary EU Law, Secondary EU Law and National Law in the Field of Direct Taxation’ (2024) European Business Law Review, issue 1, 1-48.

42 Case C-247/08 Gaz de France [2009] ECLI:EU:C:2009:600.

43 FR: Law No. 84-1 of 3 January 1994.

authorities' decision, which referred the case for a preliminary ruling to the CJEU.

4.021 The CJEU was clear: the wording of the Annex did not include the SAS as a qualifying legal form, nor did the French enumeration include a flexibility remark by referring to companies incorporated under French law in general. As such, the CJEU confirmed the static interpretation of the Annex to the Parent-Subsidiary Directive. Thus, if a legal form is not included in the Annex, it is not in scope of the Parent-Subsidiary Directive and, consequently, it cannot automatically benefit from the directive. However, if a company is not in scope of the Parent-Subsidiary Directive, this does not affect the application of the fundamental freedoms.[44] In other words and in relation to Gaz de France: even though Germany was not held to exempt the dividend distribution to the French SAS under the Parent-Subsidiary Directive, it was still not entitled to treat a dividend distribution to the SAS less favourably than a dividend distribution to a comparable German legal form. In this situation, the fundamental freedoms serve as a safety net. That safety net is also present for situations in the context of the European Economic Area (EEA), as the freedom of establishment or non-discrimination principle in the EEA Agreement would prohibit that dividend distributions to a parent company in Iceland, Liechtenstein or Norway are treated less favourably than a dividend distribution to a comparable parent company in the same jurisdiction as the distributing company.[45]

4.022 During the discussions on amending the Annex to the Parent-Subsidiary Directive in 2003, Germany suggested to amend the legal forms listed for Germany by adding 'other entities constituted under German law subject to German Corporate Tax'. Six Member States[46] opposed this amendment, because they considered that the explanations provided by the German delegation are not sufficient to clarify that such entities are corporate vehicles

44 Also see Case C-303/07 Aberdeen Property Fininvest Alpha [2009] ECLI:EU:C:2009:377, point 28; Case C-379/05 Amurta [2007] ECLI:EU:C:2007:655, point 24; and Case C-374/04 Test Claimants in Class IV of the ACT Group Litigation [2006] ECLI:EU:C:2006:773, point 54. In the latter case, the CJEU judged: 'The mere fact that, for holdings to which Directive 90/435 does not apply, it is for the Member States to determine whether, and to what extent, a series of charges to tax and economic double taxation are to be avoided and, for that purpose, to establish, either unilaterally or through DTCs concluded with other Member States, procedures intended to prevent or mitigate such a series of charges to tax and that economic double taxation, does not of itself mean that the Member States are entitled to impose measures that contravene the freedoms of movement guaranteed by the Treaty.'

45 See Case C-521/07 Commission v Netherlands [2009] ECLI:EU:C:2009:360.

46 Austria, Finland, Ireland, Poland, Sweden and the UK.

that meet the requirements set out in Articles 2 and 3 of the directive.[47] Five other Member States[48] made a comparable request as Germany, but they faced less opposition. The Spanish government requested explicit reassurance that any approval on amending the Annex to the Parent-Subsidiary Directive would not have any effects on future discussions when amending the Merger Directive.[49] This was granted by an explicit reference in the minutes of the meeting.[50] In 2003, the Annex to the Parent-Subsidiary Directive listing the qualifying legal forms was extended.[51] The newly added companies also concerned the Societas Europaea (SE) and the Societas Cooperativa Europaea (SCE), since the SE is a public limited-liability company and the SCE is a cooperative society, both similar in nature to other forms of company already covered by the Parent-Subsidiary Directive.[52]

In the meantime, more Member States amended the list of qualifying legal forms by adding to the specifically mentioned legal forms that also 'companies incorporated under the laws of Member State X and subject to corporate tax in Member State X'[53] would qualify for application of the Parent-Subsidiary Directive. On the one hand, this could resolve issues as mentioned under the CJEU *Gaz de France* case, because newly introduced legal forms could automatically qualify in scope of the Parent-Subsidiary Directive. On the other hand, the reference to being subject to tax in that same Member State could give rise to discussions. Being subject to tax is a separate criterion for a qualification as a company of a Member State, that should not in itself play a role in determining the qualifying legal form. To the contrary, it could also be seen as a way to avoid that certain domestic legal forms that are, for instance, being considered transparent in the state of incorporation are treated as a 'company' for Parent-Subsidiary Directive purposes. Therefore, as long as the addition of **4.023**

47 European Council, 31 October 2003, 14237/03 FISC169, p. 2.

48 Austria, Finland, Greece, the Netherlands and Poland.

49 In other words: Spain did not want that adding or removing legal forms from the Parent-Subsidiary Directive would have an immediate and automatic impact on the list of qualifying legal forms in the Annex to the Merger Directive. The relation between the Parent-Subsidiary Directive and the Merger Directive, that were both adopted on the same date, is close. That also applies to interpretational issues, as was decided by the CJEU in Case C-371/11 Punch Graphix [2012] ECLI:EU:C:2012:647.

50 European Council, 31 October 2003, 14237/03 FISC169, 2. Also see European Council, 16 December 2003, 15637/03 FISC205, 2.

51 Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ 2003 L7/41, preamble point 4. Also see C. Brokelind, 'The proposed amendments to the Parent-Subsidiary Directive: Some progress?' (2003) European Taxation 2003, issue 12, 451.

52 Ibid, preamble point 5.

53 Austria, Belgium, Croatia, Denmark, Germany, Greece, France, Luxembourg, the Netherlands and Spain.

the subject-to-tax criterion for determining a qualifying legal form is limited to that latter purpose of excluding legal forms being tax transparent according to their state of incorporation, no harm would be done.

3. Resident of a Member State

4.024 As a second element for a company to be in scope of the Parent-Subsidiary Directive, the company should, according to the tax laws of a Member State, be considered to be resident in that Member State for tax purposes and, under the terms of a double taxation agreement concluded with a third State, not be considered to be resident for tax purposes outside the EU.

4.025 The 1969 proposal for the Parent-Subsidiary Directive, however, included as a requirement for qualifying as a parent company that the company should be 'governed by the laws of a Member State'.[54] Germany considered this a too vague requirement, especially since the place of effective management could be located in another state than the state of incorporation.[55] The other six Member States did not see any harm in the proposed wording. Germany then suggested a new phrasing, requiring that both the place of incorporation and the place of effective management should be in the same Member State.[56] Under this proposal, dual resident companies could not qualify as a 'company of a Member State' and, thus, not benefit from the Parent-Subsidiary Directive. In the amended 1970 proposal, where a qualifying company should meet three cumulative requirements, the residency requirement was rephrased. In that process, the suggestions by Germany were taken into account in such a way that incorporation alone would not suffice, but the German suggestions were not included as suggested. It would require a company having its fiscal domicile in a Member State and not, under a double tax treaty, be considered a tax resident of a non-EU Member State.[57] Under the approach that was eventually adopted, it was not required that the place of incorporation and the place of residence[58] were in the same Member State. The basic concept of denying the benefits of the Parent-Subsidiary Directive to companies that, under a tax treaty with a non-EU Member State, were considered to be a resident outside the EU was accepted and is still valid.

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54 Proposal for the Parent-Subsidiary Directive, COM(69)6, OJ 1969 C39, 7, Article 2.

55 Effectively, Germany appeared to want to exclude dual resident companies from the scope of the Parent-Subsidiary Directive.

56 European Council, 5 May 1969, R/673/69 (ECO92), 3.

57 European Council, 10 July 1970, R/1538/70 (ECO154), Annex, 1.

58 In more common terms: place of effective management.

As indicated before, the discussions on the introduction of the Parent-Subsidiary Directive turned cold in the early 1970s. Around 1985, the European Commission and European Council picked up where they left off. The French language version of the renewed proposal of the Parent-Subsidiary Directive included the requirement of a company having its 'domicile fiscal' – in French – within the EU. Some Member States had concerns about the use of the term 'domicile'. Therefore, the minutes of the 1988 Council meetings noted that in the English language version the term 'domicile' should be replaced by 'having its residence'.[59] **4.026**

I understand the final phrasing of the requirement on the residency of the company. Many Member States apply different criteria for a company to be a tax resident in their jurisdiction, like incorporation or place of management. The latter is a more material criterion, which is established by taking into account all facts and circumstances, while the former is a more formal criterion. From that perspective, it is reasonable to require that, besides meeting a formal criterion that in itself can be considered the first element as discussed in Section C.2, the actual residence should be within the EU as well. That requirement would also be met if the place of management is in a non-EU Member State with which the Member State of incorporation has no tax treaty, as then the company is still considered to be a resident of the Member State of incorporation. Only when a bilateral tax treaty would actually exist and its application would lead to the company being a resident of the non-EU contracting state, the company concerned is not considered to be resident within the EU and as such cannot benefit from the Parent-Subsidiary Directive. **4.027**

Irrespective of the above, I am ambivalent towards the separation of the 'residence' requirement and the 'subject to tax' requirement. In traditional international tax law, a company can be considered a resident if it, by reason of for instance incorporation or place of management, is fully liable to tax therein.[60] Under international tax law, therefore, residency has two elements, while under the requirements of the Parent-Subsidiary Directive, residency and 'subject to tax' were split. It can be questioned whether this split is correct and, thus, that both requirements should actually be combined to one criterion or that references to 'residency' should be removed from that criterion. Differently, one could also argue that being 'liable to tax' under the residency requirement in the tax treaty definition should be interpreted differently from **4.028**

59 European Council, 11 January 1988, 4135/88 FISC2, 3.

60 See Article 4, paragraph 1 OECD Model Tax Convention.

being 'subject to tax' under that specific separate criterion within the Parent-Subsidiary Directive.

4.029 An Indian tax court judged that 'liable to tax' and 'subject to tax' actually are different requirements.[61] A company is 'liable to tax' if it is within the scope of, for instance, corporate income tax because it meets a certain criterion, like incorporation or place of management. Under a different interpretation, a loss-making company could not be in scope of a tax treaty. The Indian tax courts interpret 'subject to tax' more in a way that the company should actually pay tax. This differentiation between concepts also follows from a grammatical interpretation following the English language.[62] If the interpretation by the Indian courts would be transposed on the requirements of the Parent-Subsidiary Directive, the co-existence of the residency requirement – only involving a more formal 'liable to tax' criterion – and the 'subject to tax' criterion can be upheld.[63] To me, this would be the preferred approach.

4. Subject to tax

4.030 The third element that needs to be met for qualifying as a 'company of a Member State' is that the company should be subject to one of the listed taxes,[64] without the possibility of an option or of being exempt, or to any other tax which may be substituted for any of those taxes.

4.031 Originally, it was not intended that parent companies or subsidiaries that are not subject to tax in the state where they have their seat would be in scope of

61 See M. Butani, S. Kejriwal and A. Singh, 'Budget 2021: India Defines "Liable to Tax" – Will It Facilitate or Fuel the Debate on Interpretation of Tax Treaties?' Kluwer International Tax Blog 15 February 2021 (accessed 4 March 2024).

62 See in that respect A. Scapa and L.A. Henie, 'Avoidance of Double Non-Taxation under the OECD Model Tax Convention' (2005) Intertax, issue 6-7, 271-272; and D. Ward and others, 'A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries' (1996) Canadian Tax Journal, issue 2, 472.

63 Also see F. Pötgens, 'Inwonerschap van entiteiten onder belastingverdragen en de onderworpenheidseis' (2024) MBB 2024, issue 6. The author, however, limits his contribution to the differences between 'liable to tax' and 'subject to tax' from an international tax perspective, without addressing the discussion in relation to the Parent-Subsidiary Directive.

64 Just like companies incorporated under Gibraltar law were not considered 'companies incorporated under the law of the United Kingdom', the corporation tax that has to be paid in Gibraltar was not considered a 'corporation tax in the United Kingdom'. See Case C-458/18 GVC Services [2020] ECLI:EU:C:2020:266, points 39-40. As profit distributions to companies subject to Gibraltar corporate income tax law are not considered to be in scope of the Parent-Subsidiary Directive, another preliminary ruling request was necessary to decide whether these situations are compatible with the freedom of establishment and the free movement of capital. See Case 287/23 Entain Services (Bulgaria) [2024] ECLI:EU:C:2024:418.

the Parent-Subsidiary Directive.[65] This is not reflected in the final wording of the requirement. In the third element of the definition, it is only determined that the company is subject to tax, not where it should be subject to tax.

It does raise the question of when a company actually is subject to tax. This question was answered by the CJEU in the *Wereldhave Belgium* decision.[66] The case concerned dividend distributions made by the Belgian resident company Wereldhave Belgium to its two Dutch resident shareholders Wereldhave International NV (35%) and Wereldhave NV (44%). Both Dutch shareholders applied the rules for fiscal investment institutions in the Netherlands. As they met all the conditions, the profits from both NVs were taxed at a corporate income tax rate of 0%. As Belgium was of the opinion that, due to the 0% corporate income tax rate, the Dutch shareholders were not subject to tax in the meaning of the Parent-Subsidiary Directive, it did not apply a withholding tax exemption to the dividend distributions. **4.032**

The CJEU pointed out that Article 2(a)(iii) of the Parent-Subsidiary Directive laid down a positive criterion for qualifying (i.e., being subject to the tax in question) and a negative criterion (i.e., not being exempt from that tax and not having the possibility of an option).[67] The establishment of both those criteria leads to the conclusion that the condition laid down in Article 2(a)(iii) of the Parent-Subsidiary Directive does not merely require that a company should fall within the scope of the tax in question, but also seeks to exclude situations involving the possibility that, despite being subject to that tax, the company is not actually liable to pay that tax.[68] **4.033**

This argumentation appears contrary to the preferred reading of the 'residence' requirement under Section C.3, where 'liable to tax' as the requirement of residency is interpreted as 'falling within the scope of the tax'. Apparently, the CJEU includes 'falling within the scope of the tax' in the condition of being 'subject to tax' under Article 2(a)(iii), instead of 'liable to tax' as element under Article 2(a)(ii). That, again, raises the question on the relevance of the residency requirement. **4.034**

In relation to the question of whether a company that is subject to a 0% corporate income tax can be considered 'subject to tax', the CJEU continues by **4.035**

65 European Council, 9 July 1990, 7384/90 FISC61, 5. Originally, this already was proposed to be included in the minutes; see European Council, 11 January 1988, 4135/88 FISC2, 2.

66 Case C-448/15 Wereldhave Belgium [2017] ECLI:EU:C:2017:180.

67 Case C-448/15 Wereldhave Belgium [2017] ECLI:EU:C:2017:180, point 31.

68 Case C-448/15 Wereldhave Belgium [2017] ECLI:EU:C:2017:180, point 32.

judging that such a company, formally, is not exempt from that tax, but that it, in practical terms, is in the same situation as a situation in which it is not liable to pay that tax.[69] I doubt whether this is a correct argumentation, as being 'liable to tax' would mean that a company is generally in scope of the tax concerned. Both a company that is regularly taxed, a company that is subject to a 0% corporate income tax rate and a company that can apply an objective exemption are liable to tax, but might not be subject to tax. Some countries, like the Netherlands, even consider a subjectively exempt company like a pension fund to be 'liable to tax'; especially because the company has a legal form that would qualify within the scope of the Dutch corporate income tax but under a later article is considered to be tax exempt for its entire profit. I, therefore, assume that the CJEU meant to say that a company subject to a 0% corporate income tax rate is comparable to a company that is not subject to tax instead of liable to tax. The CJEU concludes that the inclusion in national legislation of a provision whereby a specific category of companies may, in certain circumstances, be entitled to be taxed at a 0% rate is tantamount to not subjecting those companies to that tax.[70] Effectively, the CJEU implies that a company that is liable to corporate income tax should actually pay corporate income tax in order to benefit from the Parent-Subsidiary Directive. From a Dutch tax perspective, the outcome of the judgment can be considered debatable. It is, however, more clear how the CJEU approaches the 'subject to tax' criterion.

4.036 The outcome of the CJEU *Wereldhave Belgium* judgment was in line with the position that the Netherlands had taken in the negotiating phase of the Parent-Subsidiary Directive. Essentially, the Netherlands requested to exclude qualifying shareholdings in Dutch fiscal investment institutions from the scope of the Parent-Subsidiary Directive, as they were subject to 0% Dutch corporate income tax.[71] If shareholdings in Dutch fiscal investment institutions would not be excluded, the EU parent company would benefit from a participation exemption on the Dutch sourced dividends, while the profits of the Dutch fiscal investment institution would escape the levy of corporate income tax in the Netherlands as well.[72] The Netherlands therefore proposed to exclude the application of the Parent-Subsidiary Directive, if the shares held in the

69 Case C-448/15 Wereldhave Belgium [2017] ECLI:EU:C:2017:180, point 33. In this reading, the CJEU appears to incorrectly distinguish between being 'liable to tax' and 'subject to tax'.

70 Case C-448/15 Wereldhave Belgium [2017] ECLI:EU:C:2017:180, point 34.

71 European Council, 12 June 1989, 7322/89 FISC92, 6.

72 European Council, 28 March 1984, 6048/84 FISC27, 4.

subsidiary could reasonably be qualified as an investment.[73] According to the European Commission, this was not necessary, as it was already required for qualifying within the scope of the Parent-Subsidiary Directive that both the parent company and the subsidiary should be subject to tax in the state where they have their seat.[74] Apparently, but without explicit reference, the European Commission already took the perspective that 'subject to tax' means that a tax should actually be paid, which is not the case when applying a 0% tax rate. It took until 2017, when the CJEU issued its *Wereldhave Belgium* judgment, to get formal clarity on the matter.

Other country-specific situations were discussed in the light of the 'subject to tax' criterion as well. The European Commission and the Council, for instance, indicated that the German Kapitalanlagegesellschaft was not covered by Article 2 of the Parent-Subsidiary Directive. The European Commission and the Council explicitly remarked that this is only the case insofar they are not subject to corporate income tax.[75] In relation to Spanish tax transparent companies and Portuguese companies which are in principle subject to corporation tax, but which are at the same time exempt and whose profits are taxed in the hands of their partners, the Parent-Subsidiary Directive would also not apply.[76] **4.037**

Another specific situation related to Ireland. As Ireland has two forms of corporate income tax, the Irish delegates requested the Council to clarify that it would be sufficient for a company to only be subject to 'one of these taxes'. In the original enumeration of taxes, it already included a reference to 'income tax, or corporate profits tax, or both' in relation to the covered taxes for Ireland. The Irish delegates, however, explicitly wanted the first sentence of the provision to make clear that being subject to 'one of the taxes' would be sufficient.[77] This amendment was accepted and is now included in the phrasing of the 'subject to tax' criterion. **4.038**

5. Permanent establishment

Until 2005, only profit distributions between qualifying legal forms were covered by the Parent-Subsidiary Directive. Consequently, if a qualifying company A held all the shares in another qualifying company B, but the shares **4.039**

73 European Council, 28 March 1984, 6048/84 FISC27, 4.
74 European Council, 18 April 1984, 6446/84 FISC42, 2.
75 European Council, 12 June 1989, 7322/89 FISC92, 6.
76 European Council, 9 July 1990, 7384/90 FISC61, 5.
77 European Council, 11 January 1988, 4135/88 FISC2, 3.

in company B were allocated to a permanent establishment in another EU Member State, discussions could arise on whether profit distributions to that permanent establishment were in scope of the Parent-Subsidiary Directive. Technically, not applying the directive's benefits in such a situation could be deemed undesirable, as a permanent establishment is still part of the qualifying head office from a civil law perspective. Only for tax purposes, the tax bases are being distinguished between head office and permanent establishment.

4.040 The CJEU, in the meantime, had decided comparably in its *Saint Gobain*-judgment.[78] The case concerned the French company Saint-Gobain SA that held, via its German permanent establishment Saint-Gobain ZN, almost all the shares in the German resident companies Grünzweig AG and Gevetex GmbH. Saint-Gobain ZN and the two German companies formed a tax consolidated group under German law, with the permanent establishment as the parent company of the group. In 1988, Grünzweig AG received dividends from a Swiss and an Austrian subsidiary, and Gevetex GmbH received dividends from an Italian subsidiary. Following the existence of the tax consolidated group, these dividends were allocated to Saint-Gobain ZN as the head of the consolidated group. Germany, however, denied Saint-Gobain ZN the application of the German participation exemption for dividends received, because the participation exemption could only be applied to unlimited taxpayers. In other words: a German resident company could apply the participation to dividends received, but a permanent establishment could not. The CJEU judged that the difference in treatment to which permanent establishments of non-resident companies are subject in comparison with resident companies, as well as the restriction of the freedom to choose the form of secondary establishment, must be regarded as constituting a single composite infringement of the freedom of establishment.[79] The infringement could not be justified.

4.041 Even though the case was not in scope of the Parent-Subsidiary Directive – both because of the material requirements and the fact that the case related to a year in which the directive was not yet applicable – the CJEU applied primary EU law principles to the unequal treatment by Germany. Effectively, the CJEU did not allow a local permanent establishment – or, in the words of the CJEU: a branch – to be treated less favourable than a local company. In principle, the only difference is the legal shell of both, as the local permanent

78 Case C-307/97 Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt [1999] ECLI:EU:C:1999:438.

79 Case C-307/97 Compagnie de Saint-Gobain v. Finanzamt Aachen-Innenstadt [1999] ECLI:EU:C:1999:438, point 43.

establishment usually will be incorporated under the laws of another EU Member State.

4.042 At the moment of the CJEU's *Saint Gobain* judgment, the Parent-Subsidiary Directive had already entered into force. The judgment led to a proposal for amending the Parent-Subsidiary Directive.[80] As of 2005, the Member States were required to also apply the Parent-Subsidiary Directive to profit distributions to permanent establishments in an overall EU context.[81]

4.043 This amendment of the material scope of application of the directive also required the amendment of Article 2, by introducing a definition of the concept of a 'permanent establishment'. The definition was not yet included in the original proposal, though. A textual suggestion for the definition of a permanent establishment was first made at 22 September 2003.[82] A permanent establishment was defined as a 'fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on'. The European Commission suggested a wording that was identical to the definition included in the Interest & Royalties Directive, which, on its turn, is close to the PE-definition from Article 5 of the OECD Model Tax Convention [Chapter 15].[83] All EU Member States agreed to the inclusion of this definition, except Germany.[84] Later, Germany requested that the definition of a permanent establishment would be taken from Article 5, paragraphs 2 to 4 of the OECD Model Tax Convention and, when a participation would be held via a permanent establishment, to add a beneficial ownership requirement comparable to that in the Interest & Royalties Directive.[85] A day later, the Council discussed an alternative definition for permanent establishment, that is, as we know now, the currently existing definition: 'For the purposes of this Directive the term "permanent establishment" means a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on insofar as the profits of that place of business are subject to tax in the Member State in which it is situated by virtue of the relevant bilateral tax treaty or, in the

80 Proposal for a Council Directive amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, COM(2003)462 final, 5, point 19.

81 This was added to Article 1 paragraph 1 of the Parent-Subsidiary Directive by Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ 2003 L7/41.

82 European Council 22 September 2003, 12740/03 FISC 130, 3.

83 European Council 22 September 2003, 12740/03 FISC 130, 3.

84 European Council, 30 September 2003, 13072/03 FISC 134, 3.

85 European Council, 30 October 2003, 14134/03 FISC 167, 6.

absence of such a treaty, by virtue of national law.'[86] No further remarks were made anymore.

4.044 While the original idea was to stay close to the definition of permanent establishment that most EU Member States were familiar with from the application of the OECD Model Tax Convention, the German request for amendments shifted away from that perspective. The addition of the last part of the definition, that is, 'insofar as the profits of that place of business are subject to tax in the Member State in which it is situated by virtue of the relevant bilateral tax treaty or, in the absence of such a treaty, by virtue of national law', to my understanding should not be regarded as part of the definition of what a permanent establishment actually is. In my opinion, it should be regarded as the 'subject to tax' rule of Article 2(a)(iii) of the Parent-Subsidiary Directive applied to permanent establishments. Apparently, the addition should safeguard that the profits allocated to a permanent establishment are taxed sufficiently at that level.

4.045 By phrasing the definition in its current form, the definition consists of two elements: an actual material definition that is close, not to say identical, to the OECD definition – but of course limiting the scope to internal EU situations – and a subject-to-tax requirement. From a more formal perspective, it would have been my preference to split those elements of the definition of a 'permanent establishment of a Member State' in letters a and b, comparable to the elements of the definition of a 'company of a Member State'.

4.046 Even though the definition implies that the concept of a permanent establishment should be interpreted following the lines of the OECD concept, as it takes the same elements into account, no formal references to the OECD definition are made that would support this interpretation. As such, it is technically up to the individual Member States to interpret the definition in the Parent-Subsidiary Directive upon implementation of the directive. The final say would be to the CJEU. Of course, the CJEU can still indicatively use OECD sources for the interpretation of the EU concept of permanent

86 European Council 31 October 2003, 14237/03 FISC 169, 6

establishment.[87] To my knowledge, the CJEU did not yet define this concept from the perspective of the Parent-Subsidiary Directive.[88]

D. ARTICLE 3 AND ITS CONSTITUTIVE ELEMENTS

1. Introduction

Once it is determined whether a company of a Member State – or its permanent establishment – qualifies within the scope of the Parent-Subsidiary Directive, it has to be decided whether the relationship between two companies, directly or through a permanent establishment, qualifies as well. This relationship requirement is substantiated in Article 3 of the Parent-Subsidiary Directive. In Article 3, paragraph 1 of the directive, the minimum shareholding requirement is defined that makes a company of a Member State a parent company (Section D.2). The company of a Member State in which these qualifying shares are held is considered the subsidiary (Section D.3). **4.047**

In Article 3, paragraph 2, certain policy and implementing options are included. The first policy option relates to the qualification of the relationship between the parent company and its subsidiary by providing for the option to replace the 'holding in the capital' criterion with a 'voting rights' criterion (Section D.4). The second policy option relates to granting the right not to apply the directive's benefits if the shares, or voting rights, are not held for a certain minimum holding period (Section D.5). This second option essentially stands apart from the actual qualification as 'company of a Member State', 'parent company' or 'subsidiary', but relates to the consequences of the directive for situations that based on the definitions would be in scope of the Parent-Subsidiary Directive. **4.048**

87 Pragmatically, the CJEU could easily ignore the differences between the EU term and the term under international tax law. See Case C-414/06 Lidl Belgium [2008] ECLI:EU:C:2008:278. Also see T. Rønfeldt, 'Internal and external neutrality: On the significance of the allocation of the powers of taxation on the choice between a permanent establishment and a subsidiary in relation to the Danish territoriality principle' (2012) Intertax, issue 1, 15.

88 Other OECD-inspired concepts were interpreted by the CJEU, like the 'beneficial ownership' requirement in the Interest & Royalties Directive (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16 N Luxembourg 1 and others [2019] ECLI:EU:C:2019:134) and the principle of 'foreseeable relevance' in the Directive on Administrative Cooperation (Case C-437/19 État du Grand-duché de Luxembourg v L [2021] ECLI:EU:C:2021:953).

2. Parent company

(a) Direct shareholding in subsidiary

4.049 A situation is in scope of the Parent-Subsidiary Directive when a company of one EU Member States holds a shareholding of at least 10% in the company of another EU Member State. This means that the companies, besides the conditions of Article 2 of the Parent-Subsidiary Directive, should meet a minimum shareholding threshold of 10%.

4.050 The required minimum percentage has not always been 10%. In the 1969 proposal for the Parent-Subsidiary Directive, a minimum shareholding of at least 20% was required to qualify as a parent company. In the preparatory documents, the European Commission acknowledged that the required percentage took into account the differences among the Member States. At that time, Belgium required a company to hold only one share to qualify as a parent company, while France required a shareholding of at least 10% in the capital of the subsidiary, and other countries – that is, Germany, Luxembourg and the Netherlands – required at least 25%. The latter countries adhered to that threshold.[89] Later, Italy joined Germany and the Netherlands, where Luxembourg changed their perspective and deemed a 20% threshold acceptable as well.[90]

4.051 After the accession of Denmark, Ireland and the United Kingdom, the discussions on the proposed shareholding threshold in the Parent-Subsidiary Directive continued. Denmark and Ireland wanted a minimum shareholding requirement of at least 25%, while the United Kingdom would also accept a participation between 20% and 25%. Italy favoured 25% as well, but indicated that it was only a provisional position taken.[91] Especially Denmark played a significant role, by explicitly mentioning that it could not accept the Parent-Subsidiary Directive if the required threshold would be below 20% or 25%.[92] Later, the Member States accepted the 25% threshold.[93] A representative of the European Commission had already clarified earlier that the required threshold had to be applied as a percentage of the entire share capital of the subsidiary, irrespective of whether these would include or correspond with voting rights.[94]

89 European Council, 5 May 1969, R/673/69 (ECO92), 5.
90 European Council, 27 July 1970, R/1644/70 (ECO164), 6.
91 European Council, 14 January 1974, R/129/74 (FIN38), 3.
92 European Council, 14 January 1974, R/129/74 (FIN38), 4.
93 European Council, 18 April 1984, 6446/84 FISC42, 2.
94 European Council, 14 January 1974, R/129/74 (FIN38), 7. Also see Section D.4.

In its 2003 proposal, the European Commission suggested to lower the required shareholding threshold from 25% to 10%, without any step in between, aimed at increasing the number of companies that would be able to benefit from the relief provided for in the Directive.[95] Eight Member States, however, had issues with the wording of the proposal: six Member States[96] could not agree, two Member States[97] expressed concerns.[98] As a compromise, the European Commission suggested to gradually lower the 25% threshold to 10%, via a 20% threshold as of 2005 and a 10% threshold as of 2006.[99] Germany opposed to the compromise text,[100] later joined by Belgium, Greece and Poland.[101] Their argument was mainly based on the fact that two threshold reductions in two years was too much. A few weeks later, a new compromise text suggested reducing the minimum shareholding threshold to 20% in 2005, to 15% in 2007 and to 10% in 2009.[102] Consequently, the 25% threshold was gradually lowered from 25% to 10% in order to extend the benefits of the Parent-Subsidiary Directive.[103] **4.052**

In addition to requiring a minimum percentage of, now, 10%, the Parent-Subsidiary Directive requires the 10% to be held in the capital of the subsidiary. In the negotiation phase, the United Kingdom demanded a clear definition of the term 'capital' in order to avoid divergent interpretations across the Member States.[104] Upon the United Kingdom's request, the European Commission provided the Council with an information note on the concept of 'capital' and its relation with the notion of 'capital' as included in the OECD Model Tax Convention.[105] In the end, the European Commission advised to keep the proposed reference to the concept of 'capital' in the Parent-Subsidiary Directive and the interpretation to the concept as provided under the OECD **4.053**

95 Explanatory Memorandum to the Proposal for a Council Directive amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, COM(2003)462 final, 6.

96 Belgium, Denmark, Germany, Greece, Portugal and Spain. A week later, Germany changed its position to making a scrutiny reservation; see European Council 22 September 2003, 12740/03 FISC 130, 4.

97 Czech Republic and Poland.

98 European Council, 16 September 2003, 12552/03 FISC126, 4.

99 European Council, 13 October 2003, 13510/03 FISC143, 2.

100 European Council, 21 October 2003, 13793/03 FISC161, 6.

101 European Council, 30 October 2003, 14134/03 FISC167, 6.

102 European Council, 31 October 2003, 14237/03 FISC169, 6-7.

103 Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ 2003 L7/41, preamble point 7.

104 European Council, 22 February 1989, 4769/89 FISC24, 2.

105 European Council, 14 March 1989, 5493/89 FISC36.

Model Tax Convention.[106] The United Kingdom strongly disagreed and extensively motivated why the European Commission was incorrect, starting by mentioning that the OECD Model Tax Convention nor its Commentaries contain any definition of 'capital' either.[107] The United Kingdom referred to the CJEU *Felicitas* judgment:[108]

> It should first be stated that the concept in question is contained in a provision of Community law which does not refer to the law of the Member States in order to determine its meaning and scope. The harmonization of taxes such as capital duty on the raising of capital, not only in relation to the rates but also to the structure thereof, implies that the basis of assessment is determined in each Member State on the basis of objective criteria, having a uniform scope within the Community and free from the influence of national laws. It follows that the interpretation of the concept at issue, considered in its entirety, may not be left to the discretion of each Member State. It is therefore necessary to provide the national court with criteria which will enable it to determine whether the organization in question fulfils the criteria laid down by the Community rules.

4.054 Without a clear definition of 'capital' in the Parent-Subsidiary Directive, the UK concluded that it could take many years before the CJEU would provide clarity on the correct interpretation of the notion of 'capital'.[109] Therefore, they suggested, among others, to introduce a definition of 'capital', including a voting rights criterion.[110] During the next meeting, it was suggested as a compromise to stick to the original proposal referring to 'capital' as a general requirement, but also to allow the use of 'voting rights' as a criterion if the use of that criterion in a bilateral relation was agreed in a tax treaty.[111] This proposal was accepted.[112]

4.055 Still, the capital requirement led to a discussion on whether the right of usufruct would meet the criterion, leading to the *Les Vergers du Vieux Tauves* case.[113] In that case, a Belgian company (BEPA SA) held all the shares in the capital of another Belgian company (NARDA SA). In 1999, Les Vergers du Vieux Tauves SA purchased the usufructuary rights over the shares in NARDA SA for a period of ten years from BEPA SA. All companies were incorporated under Belgian law and Belgian tax residents.

106 Ibid, 2.
107 European Council, 24 April 1989, 6220/89 FISC63, 2.
108 Case 270/81 Felicitas [1982] ECLI:EU:C:1982:281, point 14.
109 European Council, 24 April 1989, 6220/89 FISC63, 3.
110 Ibid, 4.
111 European Council, 28 April 1989, 6219/89 FISC62, 8.
112 European Council, 25 May 1989, 6771/89 FISC78, 6
113 Case C-48/07 Les Vergers du Vieux Tauves [2008] ECLI:EU:C:2008:758.

In the years 2000 to 2002, NARDA SA distributed dividends to Les Vergers du Vieux Tauves SA. The Belgian tax authorities refused the application of any method for the avoidance of double taxation to the recipient of the dividends because the company was not the full owner of the shares. In the end, the Belgian court referred the case to the CJEU for a preliminary ruling on whether a right of usufruct could be considered comparable to a shareholding in the capital of a subsidiary.[114] **4.056**

The CJEU dismissed the arguments that it could not judge in the case at hand as that concerned a fully internal situation. Referring to settled case law,[115] the CJEU argued that it, in principle, would not be competent in fully internal situations except if it becomes clear from the implementation of a directive that is was expressly intended to apply the rules for cross-border situations in the same way as to domestic situations. In those situations, the CJEU can interpret a directive to a fully domestic situation, like in the case at hand. **4.057**

On the substantive matter, the CJEU clarifies that both Les Vergers du Vieux Tauves SA and BEPA SA have a legal relationship with NARDA SA. It adds, however, that it follows from the wording of Article 3 of the Parent-Subsidiary Directive that the concept of a holding in the capital of a company does not cover the right of usufruct held by a company over shares in the capital of another company.[116] This is confirmed by the purpose of the Parent-Subsidiary Directive.[117] The usufructuary of the shares of a company receives dividends distributed by the latter by virtue of its right of usufruct. Its legal position vis-à-vis the subsidiary is not such as to endow it with the status of shareholder, as that position results solely from the right of usufruct that has been transferred to it by the owner of the shares in the capital of the subsidiary.[118] As such, only holding rights of usufruct is not satisfactory for meeting the requirement of holding a minimum shareholding percentage in the capital of a company of another Member State as included in Article 3 of the Parent-Subsidiary Directive.[119] Probably, the certification of shares will have a comparable effect as under a right of usufruct.[120] **4.058**

114 Case C-48/07 Les Vergers du Vieux Tauves [2008] ECLI:EU:C:2008:758.

115 Case C-28/95 Leur-Bloem [1997] ECLI:EU:C:1997:369; and Joined cases C-297/88 and C-197/89 Dzodzi [1990] ECLI:EU:C:1990:360.

116 Case C-48/07 Les Vergers du Vieux Tauves [2008] ECLI:EU:C:2008:758, point 39.

117 Case C-48/07 Les Vergers du Vieux Tauves [2008] ECLI:EU:C:2008:758, point 40.

118 Case C-48/07 Les Vergers du Vieux Tauves [2008] ECLI:EU:C:2008:758, point 41.

119 Case C-48/07 Les Vergers du Vieux Tauves [2008] ECLI:EU:C:2008:758, point 44.

120 Also see A.E. de Leeuw, *Scheiding van zeggenschap en belang in familiesfeer* (Wolters Kluwer 2020) chapter 7.3.

4.059 Of course, the minimum shareholding requirement of 10% in the capital of the subsidiary is only the minimum norm set by the Parent-Subsidiary Directive. Upon implementation, Member States may opt for the application of a lower threshold. If a Member State opts to do so and explicitly addresses that it wants to apply the Parent-Subsidiary Directive's benefits to parent companies holding that lower threshold, interpretational questions can still be referred to the CJEU. The same goes for Member States distinguishing in the required minimum threshold between domestic and cross-border situations. The Netherlands implemented the Parent-Subsidiary by allowing a withholding tax exemption on dividend distributions to EU parent companies that met the exact criteria from the directive. In itself, that is correct from an EU perspective. Domestically, however, the withholding tax exemption was applied to 'participations', that is, to situations where the Netherlands parent company held a shareholding in the capital of the Dutch subsidiary of at least 5%. Effectively, EU parent companies holding a shareholding between 5% and the threshold required by the Parent-Subsidiary Directive were placed at a disadvantage. According to the CJEU,[121] this different treatment was considered an infringement to the free movement of capital.[122] As a result, the Netherlands had to apply the withholding exemption to the Portuguese parent company on the dividend distributions by its 6% and 14% Dutch subsidiaries in the same way as it would apply the exemption in a domestic situation. It only would be relieved from extending the withholding tax exemption if the avoidance of double taxation on the dividend distribution would be safeguarded by a bilateral tax treaty. In other words: The Netherlands could still levy a withholding tax if the tax treaty between the Netherlands and Portugal would force Portugal to fully credit the Dutch withholding tax. That was left for the Dutch referring court to decide. Before the Dutch tax court, however, it turned out that Portugal applied a participation exemption regime and, therefore, that the Portuguese parent company could not credit the Dutch dividend withholding tax. The Netherlands had to apply the exemption.

4.060 In case a cross-border situation is not in scope of the Parent-Subsidiary Directive, Member States can set specific domestic requirements that do not directly follow from the directive. In that case, however, it is not allowed for these additional requirements only apply to cross-border situations compared

121 Case C-379/05 Amurta [2007] ECLI:EU:C:2007:655.

122 Articles 56 and 58 TFEU. At the time of the case at hand, the required minimum shareholding percentage for EU parent companies amounted to 25%. The factual shareholding percentages of the Portuguese parent company in the Amurta case were 6% and 14%.

to domestic situations.[123] In the *ACC Silicones* case, Germany made the reimbursement of dividend withholding tax on dividend distributions to EU parent companies below the 10% threshold subject to proof that that tax cannot be set off. In situations where the tax could be set-off, it had to be demonstrated that the tax was not carried forward in favour of that company, or in favour of its direct or indirect shareholders. Also, the tax should not be deductible by that company as work-related outgoings or an operating cost. In domestic situations, this proof was not required. According to the CJEU, this requirement constituted an infringement on the free movement of capital.

Unlike the shareholding threshold as applied under the Interest & Royalties Directive (Chapter 15), the Parent-Subsidiary Directive does not require the parent company to hold a direct shareholding in the subsidiary. Even though it would be very uncommon and may be even formally impossible, profit distributions to indirect parent companies could therefore also qualify for the benefits of the Parent-Subsidiary Directive. **4.061**

(b) Shareholding via permanent establishment

Considering that as of 2005 profit distributions to an EU permanent establishment were also considered to be in scope of the Parent-Subsidiary Directive, Article 3 needed to be extended to define the parent company when a permanent establishment was used.[124] **4.062**

In the original proposal for amendment, the scope of the Parent-Subsidiary Directive was extended to include profit distributions to permanent establishments, but some qualifications as parent company while allocating shares to a permanent establishment still were not in scope. This especially related to distributions between two companies of the same Member State, while the shares in the subsidiary were allocated to a permanent establishment in another Member State.[125] The proposal was amended to include these situations shortly after.[126] At that time, only Germany opposed to the amendment,[127] especially as, according to the European Commission, the benefits of the directive should also be allowed between companies of an EU Member State while the shares **4.063**

123 See Case C-572/20 ACC Silicones [2022] ECLI:EU:C:2022:469.

124 J.N. Bouwman and M.G. de Weerdt-de Jong, however, indicate that the Parent-Subsidiary Directive could have been applied to such situations even without amendment. See J.N. Bouwman and M.G. de Weerdt-de Jong, 'Richtlijn 2003/123/EG; de aanpassing van de moeder-dochterrichtlijn' (2004) Weekblad voor Fiscaal Recht, 1579.

125 This was signalled in European Council, 16 September 2003, 12552/03 FISC126, 14.

126 European Council, 30 September 2003, 13072/03 FISC 134, 3.

127 European Council, 30 September 2003, 13072/03 FISC 134, 4.

in the EU subsidiary would be held via a non-EU permanent establishment.[128] The European Commission considered the German position an unacceptable step backwards.[129] Later, the European Council's legal services intervened by indicating that if there are legitimate alternative interpretations of Article 5 of the Parent-Subsidiary Directive with respect to its application to distributions through permanent establishments in third countries, those interpretations will remain available.[130] Apparently, this was sufficient for Germany to accept the proposed wording.

4.064 As a result, profit distributions made between qualifying companies via a permanent establishment in another EU Member State were included in the material scope of Article 1, paragraph 1 of the Parent-Subsidiary Directive, and both the 'internal situation' and the 10% requirement were included in the definition of 'parent company' of Article 3(1)(a) of the directive.[131] On the definition, the Member States were of the opinion that a payment of profit distributions to, and their receipt by, a permanent establishment of a parent company should give rise to the same treatment as that applying between a subsidiary and its parent.[132]

4.065 Clearly, the Parent-Subsidiary Directive does not suggest that the permanent establishment can be qualified as the parent company. It only indicates that, where shares in a subsidiary can be allocated to a permanent establishment, the head office can still be considered the parent company for the purposes of the directive.

4.066 Furthermore, the requirement describes a limited scope. It only determines that unilateral situations – from a civil law perspective – can be in scope of the Parent-Subsidiary Directive if the sole cross-border element is the use of a permanent establishment, that is, a presence from a tax perspective. The wording of the requirement, after all, indicates that when a company in Member State A holds shares in a subsidiary in Member State A via a permanent establishment in Member State B, the head office of the permanent establishment still qualifies as the parent company. Adding this specific situation was necessary because, legally, the profit is only distributed within the same EU Member

128 European Council, 31 October 2003, 14237/03 FISC169, 2.

129 European Council, 4 November 2003, 14237/1/03 FISC 169, 2.

130 European Council, 11 November 2003, 14619/03 FISC180, 3.

131 European Council, 13 October 2003, 13510/03 FISC143, 2-3.

132 Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ 2003 L7/41, preamble point 8.

State and the situation, therefore, would not qualify within the scope of the Directive. A situation concerning three EU jurisdictions – that is, a parent company in Member State A, holding shares in a subsidiary in Member State C via a permanent establishment in Member State B – already was in scope of the directive.[133] In that situation, legally, a profit distribution would be seen from the subsidiary to the parent company in another Member State. As such, only the situation would need to be resolved where the permanent establishment was the sole cross-border element.

If, however, that situation involving three EU jurisdictions would not be in scope of the Parent-Subsidiary Directive, an appeal to primary EU law would still be possible. In that respect, the CJEU's Saint Gobain case could be equally relevant (see Section C.5). Because situations in relation to the use of a permanent establishment are solely in scope of the freedom of establishment and, thus, only have an effect in intra-EU situations, an appeal to primary EU law cannot succeed if the permanent establishment is located outside the EU.[134] **4.067**

A situation that did not require an amendment of the scope of the Parent-Subsidiary Directive was the case where the parent company in Member State A holds a qualifying number of shares in a subsidiary in Member State B via a permanent establishment in Member State B. According to the European Commission, these situations can, without prejudice to the application of the TFEU principles, be dealt with on the basis of national legislation by the Member State concerned.[135] The assumption here is that the European Commission refers to Member State B, and that Member State B should be in the position to treat a local permanent establishment in the same way as it would treat a domestic entity as regards the tax treatment of profits received. Of course, it can also be argued that this situation is also already covered by Article 3(1)(a) of the Parent-Subsidiary Directive[136] (see Section D.2.a) and **4.068**

133 Still, it was suggested to introduce this situation explicitly in the Parent-Subsidiary Directive; see European Council, 13 October 2003, 13510/03 FISC 143, 3. This was not included in the Directive.

134 Comparably, see Case C-415/06 Stahlwerk Ergste Westig [2007] ECLI:EU:C:2007:651. In that case, the CJEU decided that an EU Member State's loss compensation rules in relation to a permanent establishment in the United States could not be challenged by an appeal to primary EU law. The relationship between a head office and its permanent establishment is only covered by the freedom of establishment and not by the free movement of capital. Even though the latter would have an effect in relation to non-EU Member States, the relation with the permanent establishment is not in scope of that fundamental freedom.

135 Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ 2003 L7/41, preamble point 8.

136 As would also appear from the fact that the European Council implied that this situation is already in scope of the Parent-Subsidiary Directive; see European Council 2 October 2003, 13187/03 FISC137, 12.

that Member State B already had to act in this way following the CJEU *Saint Gobain* judgment.

4.069 In relation to the 10% requirement, France signalled that fragmentation could lead to difficulties as well. In principle, it requested to aggregate all shares held by permanent establishments in order to determine whether the 10% threshold would be met.[137] France's remark concerned the situation where parent company A held a qualifying shareholding in subsidiary B, but did so via two permanent establishments in the same jurisdiction or different jurisdictions, for example, one being allocated 4% of the shares in subsidiary B and another 6%. France's request to get this situation explicitly covered in the scope of the Parent-Subsidiary Directive was not adopted in the final directive.

3. Subsidiary

4.070 The definition of a subsidiary is brief. A subsidiary should meet all conditions for being a 'company of a Member State' (see Section C) and its shares should be held by a parent company (see Section D.2). A subsidiary does not need to fulfil any other criteria on its own merits.

4. Voting rights

4.071 As mentioned before, the United Kingdom requested to define the concept of 'capital' and suggested to have that include a 'voting rights' criterion (see Section D.2.a). As a compromise, the Parent-Subsidiary Directive was not amended by the addition of a definition of 'capital', but a voting rights criterion was introduced in Article 3, paragraph 2 of the Parent-Subsidiary Directive.

4.072 By doing so, Member States were allowed, upon implementation of the directive to replace the requirement of a specified 'holding in the capital' by the holding of voting rights. According to the directive, however, that domestic voting rights criterion can only be applied to the extent this replacement would be foreseen and guaranteed by means of a bilateral agreement. According to the Council, a double tax convention should qualify as a 'bilateral agreement' required by the provision.[138] Denmark made a reservation to this remark.[139] I would think that a multilateral tax convention, like the Nordics multilateral tax treaty between Denmark, the Faroe Islands, Finland, Iceland, Norway and Sweden – that is, including three EU Member States – should also meet the

137 European Council, 16 September 2003, 12552/03 FISC126, 18-19.
138 European Council, 12 June 1989, 7322/89 FISC92, 7.
139 European Council, 25 May 1989, 6771/89 FISC78, 7.

test of being a 'bilateral agreement' for the interpretation of the voting rights criterion.

5. Minimum holding period

Article 3(2)(b) of the Parent-Subsidiary Directive introduces an optional minimum holding period requirement.[140] The basic idea is that the benefits of the Parent-Subsidiary Directive do not need to be granted to qualifying parent companies and subsidiaries, if the required shareholding is not held for an uninterrupted period of at least two years. **4.073**

The position of the requirement in Article 3 appears strange. Systematically, after all, Article 2 determines what a 'company of a member state' is, and Article 3 determines when two qualifying companies are related as 'parent company' or 'subsidiary'. The requirement of a minimum holding period could have affected the status of parent company or subsidiary, but the phrasing of the requirement does not reveal that. Related companies meeting the minimum shareholding threshold can still qualify as parent company or subsidiary within the scope of the Parent-Subsidiary Directive, but they could not apply the directive's benefits. As such, I feel the requirement could have been better placed in either Article 1, as a sort of anti-abuse provision, or in both the Articles 4 and 5, explicitly mentioning that both benefits are not applicable when the shareholding is held for a too short period of time. Practically, though, I do not think the incorporation of the optional requirement in Article 3 has led to a lot of issues. **4.074**

The minimum holding period requirement of two years should be read carefully. When a Member State opts in for the exception, it effectively requires that a parent company should hold the shares in the subsidiary for a minimum period of time. This requirement is traditionally applied to ensure a sustainable relation between the two companies. According to those Member States, it should be avoided that a company is created, immediately qualifies as a parent company, a dividend is distributed applying the benefits of the directive, and the company is dissolved again. Member States are free, though, to determine the exact time period that is considered sufficient as a minimum holding period, it being understood that the period can at a maximum be two **4.075**

140 Also see G. Maisto, 'The EC Court's interpretation of the Parent-Subsidiary Directive under the Denkavit case' (1997) Intertax, 180; D. Bouzoraa, 'The Parent-Subsidiary Directive: Denkavit's lessons' (1997) European Taxation, 14.

years. Several EU Member States implemented the requirement with a one year holding period.

4.076 This does raise the question of when the holding period requirement would start. The Parent-Subsidiary Directive itself does not clarify this. During the negotiations on the directive, Spain required that the calculation of the two-year-threshold should start at the moment of each individual dividend distribution.[141] This was not specified in the directive. It does indicate that, at least according to Spain, it was considered relevant that there would still be a sustainable relation between the profit distributing and receiving companies after the profit was actually distributed.

4.077 In the CJEU *Denkavit* judgment, the CJEU could finally give some clarity on the concept of the minimum holding period requirement.[142] It concerned three situations in which Dutch companies held shareholdings in German resident subsidiaries. At the moment of the profit distributions by the German subsidiaries, the minimum shareholding threshold was met. However, at that time, the qualifying shareholdings were not yet held for the required German minimum holding period of 1 year. Contrary to the Spanish requests that the holding period requirement should continue for the set minimum period after the profit distribution, Germany took the position that the requirement should be met at the moment of the profit distribution. As, in the cases at hand, all shares were held for an insufficient period of time, the profit distributions could not benefit from the application of the Parent-Subsidiary Directive.

4.078 The CJEU decided that the German position is contrary to a textual and teleological interpretation of the provision of the Parent-Subsidiary Directive. First, the CJEU indicates that the use of the present tense ('maintain') makes it clear that, in order to receive the tax advantage, the parent company must have a holding in the subsidiary during a certain period of time, without it being necessary for this period should have come to an end at the time when the tax advantage is granted.[143] This interpretation is confirmed by the purpose of the Directive, which is to facilitate the tax arrangements governing cross-border cooperation. Member States cannot therefore, in this regard, unilaterally introduce restrictive measures such as the requirement, as in this instance, that a minimum holding period must already have been completed

141 European Council, 14 March 1988, 4135/1/88 REV1 FISC2, 4.

142 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387.

143 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387, point 25.

when the profits in respect of which the tax advantage is sought are distributed.[144] The CJEU continues by stating that, since the optional holding period requirement would limit the scope of the Parent-Subsidiary Directive, it is to be interpreted strictly.[145]

The intervening Member States tried to address that within the Council, during the negotiations on the Parent-Subsidiary Directive, it was agreed to use relatively vague terms in order to allow for differing interpretations according to the requirements of the domestic legal systems.[146] That agreement, however, was not included in the written remarks on the drafting of the specific provision. Besides that, the remarks made in the Council were not considered relevant by the CJEU as long as they are not reflected in the actual wording of the directive.[147] In the end, the CJEU concludes that any required minimum holding period is not necessarily to be met at the moment of the profit distribution. Other alternatives are possible,[148] like levying a withholding tax with the option to request for a refund once the holding period requirement was met or by allowing an immediate withholding tax exemption if the subsidiary company lodges a security equal to the amount of the tax foregone.[149] **4.079**

In the 2017 OECD Model Tax Convention, as well as in Article 8, paragraph 1 of the Multilateral Instrument, it is added in the dividends provision – traditionally Article 10 – that the reduced withholding tax rate between the contracting states of a tax treaty can only be granted if a minimum shareholding period of 365 days is met, including the day of the distribution of the dividends. It could be questioned whether the introduction of such a requirement in an intra-EU bilateral tax treaty could also affect the position towards the optional minimum holding period requirement in the Parent-Subsidiary Directive.[150] In the Explanatory Notes to the Multilateral Instrument, the **4.080**

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144 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387, point 26.

145 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387, point 27.

146 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387, point 28.

147 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387, point 29.

148 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387, point 35.

149 Opinion of AG Jacobs on Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:186, point 34.

150 In general on this matter, see T.M. Vergouwen, *The effect of directives within the area of direct taxation on the interpretation and application of tax treaties* (Kluwer Law International 2023).

OECD remarked: 'Some Covered Tax Agreements between EU members may contain a compatibility clause providing that the EU Parent-Subsidiary Directive shall prevail over existing dividends provisions. [. . .] this paragraph just adds a minimum shareholding period to existing dividends provisions, and would not repeal the provisions of Covered Tax Agreements addressing compatibility with the Directive.'[151] As a result, the amendment of an intra-EU tax treaty should not affect policy choices made by EU Member States, especially for those who decided not to introduce a minimum holding period requirement.

4.081 It is remarkable that, even though the original Parent-Subsidiary Directive and the Merger Directive were adopted on the same date, their inter-relational aspects were not taken into account for the purpose of the minimum holding period requirement. In certain situations covered by the Merger Directive, like certain mergers or divisions, it could be argued that this should not lead to a new start of the minimum holding period. One could think of the situation where a subsidiary A is divided in two new subsidiaries B and C. In that situation, the parent company would, after the division, have interests in two companies instead of one, but substantially, both 'new' shareholdings concern the same enterprise the parent company had an interest in before the division. Even though effectively, the parent company holds the 'same' shareholding as before, the minimum holding period requirement in the Parent-Subsidiary Directive itself remains silent on whether, after the division, a new holding period starts for application of the directive's benefits.[152] I would say that there are sound arguments to take the position that – at least as long as no activities substantially change – the holding period of the pre-division company can be projected on the post-division subsidiaries.

E. CONCLUDING REMARKS

4.082 Determining the personal scope of the Parent-Subsidiary Directive appears not to be that difficult. It would require two companies from different Member States, each fulfilling the criteria of (i) having a qualifying legal form, (ii) being resident in an EU Member State, and (iii) being subject to tax. Besides that, the parent company should hold a shareholding of at least 10% in the

151 Explanatory Statement To The Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion And Profit Shifting, OECD 2017, point 123.

152 See N. van Gennip, 'Moeder-dochterrichtlijn', NLFiscaal Kennisbank Europees belastingrecht, Commentaar bij artikel 3, lid 2, onderdeel b.

subsidiary and, optionally, can be required to comply with a minimum holding period of (maximum) two years. If an EU permanent establishment is involved as the enterprise to which the shares in the profit distributing company are allocated, it is also in scope, as long as the EU permanent establishment has an EU head office.

Still, at a detailed level, some unclarities remain. Most of them probably are rather academic in nature, such as the difference between 'liable to tax' and 'subject to tax', in scope permanent establishment situations and the concurrence between the Parent-Subsidiary Directive and the Merger Directive for application of the minimum holding period requirement. I have tried to address these issues and suggest the way forward on them. **4.083**

ANNEX I

PartA

List **of companies referred to in Article 2(a)(i)**

(a) **companies incorporated under Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE) (6) and Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees (7) and cooperative societies incorporated under Council Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE) (8) and Council Directive 2003/72/EC of 22 July 2003 supplementing the Statute for a European Cooperative Society with regard to the involvement of employees (9);**

(b) **companies under Belgian law known as 'société anonyme'/'naamloze vennootschap', 'société en commandite par actions'/'commanditaire vennootschap op aandelen', 'société privée à responsabilité limitée'/'besloten vennootschap met beperkte aansprakelijkheid', 'société coopérative à responsabilité limitée'/'coöperatieve vennootschap met beperkte aansprakelijkheid', 'société coopérative à responsabilité illimitée'/'coöperatieve vennootschap met onbeperkte aansprakelijkheid', 'société en nom collectif'/'vennootschap onder firma', 'société en commandite simple'/'gewone commanditaire vennootschap', public undertakings which have adopted one of the abovementioned legal forms, and other companies constituted under Belgian law subject to Belgian corporate tax;**

(c) **companies under Bulgarian law known as: 'събирателно дружество', 'командитно дружество', 'дружество с ограничена отговорно ст', 'акционерно дружество', 'командитно дружество с акции', 'неперсонифицирано дружество', 'кооперации', 'кооперативни съюзи', 'държавни предприятия' constituted under Bulgarian law and carrying on commercial activities;**

(d) **companies under Czech law known as: 'akciová společnost', 'společnost s ručením omezeným';**
(e) **companies under Danish law known as 'aktieselskab' and 'anpartsselskab'. Other companies subject to tax under the Corporation Tax Act, in so far as their taxable income is calculated and taxed in accordance with the general tax legislation rules applicable to 'aktieselskaber';**
(f) **companies under German law known as 'Aktiengesellschaft', 'Kommanditgesellschaft auf Aktien', 'Gesellschaft mit beschränkter Haftung', 'Versicherungsverein auf Gegenseitigkeit', 'Erwerbs- und Wirtschaftsgenossenschaft', 'Betriebe gewerblicher Art von juristischen Personen des öffentlichen Rechts', and other companies constituted under German law subject to German corporate tax;**
(g) **companies under Estonian law known as: 'täisühing', 'usaldusühing', 'osaühing', 'aktsiaselts', 'tulundusühistu';**
(h) **companies incorporated or existing under Irish law, bodies registered under the Industrial and Provident Societies Act, building societies incorporated under the Building Societies Acts and trustee savings banks within the meaning of the Trustee Savings Banks Act, 1989;**
(i) **companies under Greek law known as 'ανώνυμη εταιρεία',·'εταιρεία περιορισμένης ευθύνης (Ε.Π.Ε.)'·and other companies constituted under Greek law subject to Greek corporate tax;**
(j) **companies under Spanish law known as: 'sociedad anónima', 'sociedad comanditaria por acciones', 'sociedad de responsabilidad limitada', public law bodies which operate under private law. Other entities constituted under Spanish law subject to Spanish corporate tax ('Impuesto sobre Sociedades');**
(k) **companies under French law known as 'société anonyme', 'société en commandite par actions', 'société à responsabilité limitée', 'sociétés par actions simplifiées', 'sociétés d'assurances mutuelles', 'caisses d'épargne et de prévoyance', 'sociétés civiles' which are automatically subject to corporation tax, 'coopératives', 'unions de coopératives', industrial and commercial public establishments and undertakings, and other companies constituted under French law subject to French corporate tax;**
(l) **companies under Italian law known as 'società per azioni', 'società in accomandita per azioni', 'società a responsabilità limitata', 'società cooperative', 'società di mutua assicurazione', and private and public entities whose activity is wholly or principally commercial;**
(m) **under Cypriot law: 'εταιρείες' as defined in the Income Tax laws;**
(n) **companies under Latvian law known as: 'akciju sabiedrība', 'sabiedrība ar ierobežotu atbildību';**
(o) **companies incorporated under the law of Lithuania;**
(p) **companies under Luxembourgish law known as 'société anonyme', 'société en commandite par actions', 'société à responsabilité limitée', 'société coopérative', 'société coopérative organisée comme une société anonyme', 'association d'assurances mutuelles', 'association d'épargne-pension', 'entreprise de nature commerciale, industrielle ou minière de l'Etat, des communes, des syndicats de communes, des établissements publics et des autres personnes**

morales de droit public', and other companies constituted under Luxembourg law subject to Luxembourg corporate tax;

(q) **companies under Hungarian law known as: 'közkereseti társaság', 'betéti társaság', 'közös vállalat', 'korlátolt felelősségű társaság', 'részvénytársaság', 'egyesülés', 'szövetkezet';**

(r) **companies under Maltese law known as: 'Kumpaniji ta' Responsabilita' Limitata', 'Soċjetajiet en commandite li l-kapital tagħhom maqsum f'azzjonijiet';**

(s) **companies under Dutch law known as 'naamloze vennootschap', 'besloten vennootschap met beperkte aansprakelijkheid', 'open commanditaire vennootschap', 'coöperatie', 'onderlinge waarborgmaatschappij', 'fonds voor gemene rekening', 'vereniging op coöperatieve grondslag', 'vereniging welke op onderlinge grondslag als verzekeraar of kredietinstelling optreedt', and other companies constituted under Dutch law subject to Dutch corporate tax;**

(t) **companies under Austrian law known as 'Aktiengesellschaft', 'Gesellschaft mit beschränkter Haftung', 'Versicherungsvereine auf Gegenseitigkeit', 'Erwerbs- und Wirtschaftsgenossenschaften', 'Betriebe gewerblicher Art von Körperschaften des öffentlichen Rechts', 'Sparkassen', and other companies constituted under Austrian law subject to Austrian corporate tax;**

(u) **companies under Polish law known as: 'spółka akcyjna', 'spółka z ograniczoną odpowiedzialnością', spółka komandytowo-akcyjna;**

(v) **commercial companies or civil law companies having a commercial form and cooperatives and public undertakings incorporated in accordance with Portuguese law;**

(w) **companies under Romanian law known as: 'societăți pe acțiuni', 'societăți în comandită pe acțiuni', 'societăți cu răspundere limitată', 'societăți în nume colectiv', 'societăți în comandită simplă';**

(x) **companies under Slovenian law known as: 'delniška družba', 'komanditna družba', 'družba z omejeno odgovornostjo';**

(y) **companies under Slovak law known as: 'akciová spoločnosť', 'spoločnosť s ručením obmedzeným', 'komanditná spoločnosť';**

(z) **companies under Finnish law known as 'osakeyhtiö'/'aktiebolag', 'osuuskunta'/'andelslag', 'säästöpankki'/'sparbank' and 'vakuutusyhtiö'/'försäkringsbolag';**

(aa) **companies under Swedish law known as 'aktiebolag', 'försäkringsaktiebolag', 'ekonomiska föreningar', 'sparbanker', 'ömsesidiga försäkringsbolag', 'försäkringsföreningar';**

(ab) **companies incorporated under the law of the United Kingdom;**

(ka) **companies under Croatian law known as: 'dioničko društvo', 'društvo s ograničenom odgovornošću', and other companies constituted under Croatian law subject to Croatian profit tax.**

PART B

4.084 List of taxes referred to in Article 2(a)(iii)

- **impôt des sociétés/vennootschapsbelasting in Belgium,**
- **корпоративен данък in Bulgaria,**
- **daň z příjmů právnických osob in the Czech Republic,**
- **selskabsskat in Denmark,**
- **Körperschaftssteuer in Germany,**
- **tulumaks in Estonia,**
- **corporation tax in Ireland,**
- **φόρος εισοδήματος νομικών προσώπων κερδοσκοπικού χαρακτήρα in Greece,**
- **impuesto sobre sociedades in Spain,**
- **impôt sur les sociétés in France,**
- **porez na dobit in Croatia,**
- **imposta sul reddito delle società in Italy,**
- **φόρος εισοδήματος in Cyprus,**
- **uzņēmumu ienākuma nodoklis in Latvia,**
- **pelno mokestis in Lithuania,**
- **impôt sur le revenu des collectivités in Luxembourg,**
- **társasági adó, osztalékadó in Hungary,**
- **taxxa fuq l-income in Malta,**
- **vennootschapsbelasting in the Netherlands,**
- **Körperschaftssteuer in Austria,**
- **podatek dochodowy od osób prawnych in Poland,**
- **imposto sobre o rendimento das pessoas colectivas in Portugal,**
- **impozit pe profit in Romania,**
- **davek od dobička pravnih oseb in Slovenia,**
- **daň z príjmov právnických osôb in Slovakia,**
- **yhteisöjen tulovero/inkomstskatten för samfund in Finland,**
- **statlig inkomstskatt in Sweden,**
- **corporation tax in the United Kingdom.**

5

ARTICLE 4: TREATMENT OF DIVIDENDS RECEIVED

Joris Luts and Ward Willems

1. **Where a parent company or its permanent establishment, by virtue of the association of the parent company with its subsidiary, receives distributed profits, the Member State of the parent company and the Member State of its permanent establishment shall, except when the subsidiary is liquidated, either:**
   - **refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary; or**
   - **tax such profits while authorising the parent company and the permanent establishment to deduct from the amount of tax due that fraction of the corporation tax related to those profits and paid by the subsidiary and any lower-tier subsidiary, subject to the condition that at each tier a company and its lower-tier subsidiary fall within the definitions laid down in Article 2 and meet the requirements provided for in Article 3, up to the limit of the amount of the corresponding tax due.**
2. **Nothing in this Directive shall prevent the Member State of the parent company from considering a subsidiary to be fiscally transparent on the basis of that Member State's assessment of the legal characteristics of that subsidiary arising from the law under which it is constituted and therefore from taxing the parent company on its share of the profits of its subsidiary as and when those profits arise. In this case the Member State of the parent company shall refrain from taxing the distributed profits of the subsidiary.**

   When assessing the parent company's share of the profits of its subsidiary as they arise the Member State of the parent company shall either exempt those profits or authorise the parent company to deduct from the amount of tax due that fraction of the corporation tax related to the parent company's share of profits and paid by its subsidiary and any lower-tier subsidiary, subject to the condition that at each tier a company and its lower-tier subsidiary fall within the definitions laid

down in Article 2 and meet the requirements provided for in Article 3, up to the limit of the amount of the corresponding tax due.

3. **Each Member State shall retain the option of providing that any charges relating to the holding and any losses resulting from the distribution of the profits of the subsidiary may not be deducted from the taxable profits of the parent company.**

   Where the management costs relating to the holding in such a case are fixed as a flat rate, the fixed amount may not exceed 5 % of the profits distributed by the subsidiary.
4. **Paragraphs 1 and 2 shall apply until the date of effective entry into force of a common system of company taxation.**
5. **The Council, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, shall, at the appropriate time, adopt the rules to apply as from the date of effective entry into force of a common system of company taxation.**

COMMENTARY

A. INTRODUCTION

5.001 Article 4 of the Parent-Subsidiary Directive (hereafter "PSD") is addressed to the Member State of the parent company or the Member State of its permanent establishment (hereafter "PE") and compels such Member State to provide relief for economic double taxation by granting either an "exemption" or a "tax credit" to the parent company or its PE receiving a profit distribution (paragraph 1, see section B). This main rule of Article 4 PSD is intended to give effect to the core objective of the PSD to facilitate the grouping together of companies at EU level and ensure the tax neutrality of the distribution of profits by a subsidiary established in one Member State to its parent company established in another Member State.[1]

Aside from this main rule, Article 4 PSD also sets forth a number of supporting rules on (i) the tax treatment in the Member State of the parent company or its PE of hybrid entities (subsidiaries) established in another Member State (paragraph 2, see section C), (ii) the losses and charges relating to the profit distribution and the holding of the parent company or its PE (paragraph 3, see section D) and (iii) the adoption of a "common system of company taxation" ("legal basis provision") which would terminate most obligations for the Member State of the parent company or of its PE under Article 4 PSD ("sunset clause") (paragraphs 5 and 4, see section E). **5.002**

B. PARAGRAPH 1: RELIEF FROM ECONOMIC DOUBLE TAXATION

1. Introduction

Since a subsidiary company's profits have – per assumption – already been taxed in the Member State of the subsidiary, they should not suffer an additional layer of taxation when they are distributed to the parent company or its PE. To that end, Article 4(1) PSD lays down an obligation for the Member State of the parent company or of its PE to provide relief from economic double taxation in the form of an "exemption" or a "tax credit" in respect of "distributed profits" received by the parent company or its PE, provided that some conditions are met. **5.003**

2. Exemption or credit method

(a) Addressee

Article 4(1) PSD entails a rule of conduct for "the Member State of the parent company" and "the Member State of its permanent establishment". These concepts are not, as such, defined in Articles 2 and 3 PSD. However, taking **5.004**

1 Case C-389/18 Brussels Securities SA [2019] ECLI:EU:C:2019:1132, § 35-36.

Article 2(a)(ii) and (b) PSD as the relevant context, these concepts of Article 4(1) PSD cannot be construed otherwise than referring to the Member State in which the relevant "parent company" is a tax resident and the Member State in which the PE of a "parent company" is situated.

(b) Mandatory choice

(i) General aspects

5.005 Whilst the Member States must provide for a method for relieving economic double taxation, they can choose between the two options set forth in Article 4(1) PSD.[2] They can either decide (i) to "refrain from taxing" the distributed profits, which boils down to an obligation to exempt (see section B.2.c) or (ii) to provide for a tax credit for the fraction of the corporation tax paid by the subsidiary and any lower-tier subsidiary in respect of the distributed profits (see section B.2.d).[3]

5.006 Both options are equivalent alternatives, although they may give rise to very different results in practice (see *infra*).[4] The Member States have the free choice in this regard.[5] From the perspective of Article 4(1) PSD, the Member States are therefore not bound by the way in which economic double taxation on profit distributions is relieved in a purely internal situation, between resident companies.[6] They may even decide to implement different options in respect of different Member States[7] or even vis-à-vis a single other Member State[8] and

2 Case C-68/15 X [2017] ECLI:EU:C:2017:379, § 71.

3 See recitals 9 and 11 PSD; Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82, § 31; Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774, § 44 and 103.

4 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Vienna, Verlag Österreich, 1994, 270 and G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 3-4.

5 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 270; O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 113; G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 3 and J. Kokott, *EU Tax Law* (Beck, 2022), 379, no. 50. In the case-law, see Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774, § 43-44; Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82, § 31.

6 See in that sense Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774, § 42-44. See also J. Kokott, *EU Tax Law* (Beck, 2022), 379, no. 50.

7 O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 122 and D. Berlin, *Politique fiscale, Vol. II, Commentaire J. Mégret* (Éditions de l'Université de Bruxelles 2012), 262-263, no. 1395.

8 F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 432-433; G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 561; M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag

may, for example, take into account any low taxation and/or limited level of activity of the foreign subsidiary company to make that decision.[9]

However, once a Member State has made its choice between the exemption and credit method, it must properly implement that option (i.e., in line with the requirements of Article 4(1) PSD). A Member State which has opted, when transposing the PSD, for one of the alternative methods provided for by Article 4(1) PSD cannot rely on the effects or restrictions which might have arisen from the implementation of the other method (*patere legem quam ipse fecisti*).[10] **5.007**

Despite leaving the possibility of an option to the Member States, the CJEU has held that Article 4(1) PSD is sufficiently unconditional and precise for it to have direct effect.[11] Consequently, a taxpayer may rely on that provision before the national courts and the national tax authorities[12] to claim that contrary national legislation should be set aside ("exclusionary effect") and/or that Article 4(1) PSD should be applied as a substantive rule governing the dispute in order to provide relief from double taxation ("substitutive effect").[13] **5.008**

Österreich 1994), 270; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 648, no. 14.56.

9 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 270; G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 6 and G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 648-649, no. 14.56 (with further references).

10 Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82, § 47-50; Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2022:378, § 63. Where a Member State has opted for the exemption method but has implemented that method improperly, it cannot rely on the fact that the tax treatment is still better than that which would have resulted under the credit method (Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82, § 47), nor can it compensate that improper application of the exemption method by the granting of an additional tax credit (Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2022:378, § 62-63).

11 With respect to Article 4(1)(a) PSD (or its predecessor), see Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82, § 58-65 and Joined Cases C-439/07 and C-499/07 KBC Bank, Beleggen, Risicokapitaal, Beheer [2009] ECLI:EU:C:2009:339, § 48. With respect to Article 4(1)(b) PSD (or its predecessor), see in that sense also e.g. L. De Broe and R. De Boeck, 'De Moeder-dochterrichtlijn: Europese fiscale piecemeal engineering op weg naar harmonie', in B. Peeters (ed.), *Europees belastingrecht* (Larcier 2005), 356-360, nos. 20-23 and J. Kokott, *EU Tax Law* (Beck, 2022), 379, no. 51.

12 Case C-103/88 Fratelli Costanzo [1989] ECLI:EU:C:1989:256, § 28-33.

13 However, if a Member State has opted to apply a bifurcated approach of methods (as described *supra*), there may be theoretical situations in which it is not foreseeable which approach would have been applied if the Member State would have correctly implemented the PSD with regard to the situation at hand. The question then arises, since Article 4(1) PSD has direct effect, whether taxpayers (or courts) would be able to choose the most appropriate method (compare in that respect, M. Lambooij, 'De moederdochterrichtlijn en de Nederlandse wetgeving" (1994) *FED*, 470-471).

(ii) Comparison/interaction with fundamental freedoms

5.009 The exemption and credit methods are also considered as equivalent methods from the perspective of primary EU law, provided the choice of different methods does not lead to a less beneficial treatment of dividends from other EU Member States.[14] No specific issues arise where Member States "fully" exempts[15] dividends from other EU Member States, whilst applying the credit method to domestic dividends.[16] However, where a Member State applies the exemption method to domestic dividends and the credit method to dividends from other EU Member States, the latter should benefit from an ordinary tax credit and may not be subject to a higher tax rate.[17]

5.010 Although Recital 6 to the PSD indicates that the objective of the PSD is to ensure that cooperation between companies of different Member States is not disadvantaged in comparison with cooperation between companies of the same Member State, which entails an implicit reference to the fundamental freedoms, the obligations ensuing from Article 4(1) PSD apply irrespective of how a Member State treats profit distributions between companies established in that Member State.[18]

(c) Exemption

(i) Main rule

General aspects

5.011 The main rule under Article 4(1)(a) PSD is that the Member State of the parent company and the Member State of its permanent establishment are required to "refrain from taxing" the distributed profits. According to the

14 Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774, § 46-52; Joined Cases C-436/08 and C-437/08 Haribo Lakritzen Hans Riegel and Österreichische Salinen [2011], ECLI:EU:C:2011:61, § 85; Case C-35/11 Test Claimants in the FII Group Litigation [2012] ECLI:EU:C:2012:707, § 39; Case C-47/12 Kronos International [2014] ECLI:EU:C:2014:2200, § 66. See also J. Kokott, *EU Tax Law* (Beck, 2022), 379, no. 50 and M. Tenore, 'The Parent-Subsidiary Directive', in M. Lang et al. (eds.), *Introduction to European Tax Law on Direct Taxation* (Linde 2024), 148, no. 402.

15 See in that respect section B.2.c.i.

16 Case C-47/12 Kronos International [2014] ECLI:EU:C:2014:2200, § 78 and 86.

17 Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774, § 48-52 and 72; C-436/08 and Joined Cases C-436/08 and C- 437-08 Haribo Lakritzen Hans Riegel and Österreichische Salinen [2011], ECLI:EU:C:2011:61, § 86; Case C-35/11 Test Claimants in the FII Group Litigation [2012] ECLI:EU:C:2012:707, § 39; Case C-47/12 Kronos International [2014] ECLI:EU:C:2014:2200, § 66.

18 In the same vein, G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 2.

CJEU's case-law, the reference to "refrain from taxing" should be understood as a requirement to "exempt from tax".[19]

That requirement is an "*obligation de résultat*", in the sense that it does not matter *how* the Member State (opting for the exemption method) obtains this result, as long as the exemption is effectively provided for.[20] For instance, a national system under which eligible profit distributions are first included in the taxable base and are only subsequently excluded from the taxable base by virtue of a tax-specific deduction – which corresponds to the system in place in Belgium – is *a priori* allowed.[21] However, such a system may not lead to the indirect taxation of the eligible profit distribution (see, for examples, *infra*).[22] **5.012**

The Member State of the parent company is obliged to refrain from "taxing" the profit distribution. Together with other scholars, we believe that Article 4(1) PSD not only prohibits subjecting these profit distributions to corporate tax but also bars the imposition of any other types of taxes which take into account that income for determining the taxable basis.[23] After all, the list of taxes included in the Annex of the PSD [see Annex in Chapter 4] only appears to be relevant for the purposes of determining whether a company is a "company of a Member State" (see Article 2(a)(iii) PSD) [Chapter 4].[24,25] Moreover, holding otherwise would entail a risk that the aim of the PSD could be undermined by the imposition of taxes which are labelled differently than "(corporate) income taxes" but which (partially or fully) target the same income. **5.013**

Litmus test

The most common way to implement the exemption method is to provide for a genuine exemption of the profits from the taxable basis. In other words, the **5.014**

19 Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82, § 42-43 and Joined Cases C-439/07 and C-499/07 KBC Bank, Beleggen, Risicokapitaal, Beheer [2009] ECLI:EU:C:2009:339, § 41.

20 Case C-389/18 Brussels Securities SA [2019] ECLI:EU:C:2019:1132, § 37.

21 Case C-389/18 Brussels Securities SA [2019] ECLI:EU:C:2019:1132, § 49 and Opinion AG Saugmandsgaard ØE 5 September 2019, C-389/18, § 53 et seq.

22 Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82, § 40; Case C-389/18 Brussels Securities SA [2019] ECLI:EU:C:2019:1132, § 37; Case C-295/21 Allianz Benelux [2022] ECLI:EU:C:2022:812, § 32.

23 See also J. Kokott, *EU Tax Law* (Beck, 2022), 377, no. 44.

24 M. Tenore, 'The Parent-Subsidiary Directive', in M. Lang et al. (eds.), *Introduction to European Tax Law on Direct Taxation* (Linde 2024), 142, no. 380. Seemingly *contra*: G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri"' (1992) Rivista di diritto tributario, 562.

25 The CJEU will have to decide whether that claim is valid in the pending case Case C-93/24 Banca Mediolanum – II, which concerns the application of IRAP (*Imposta Regionale sulle Attività Produttive*, a regional tax on productive activity) on a PSD-eligible dividend received by a qualifying parent company in Italy.

taxable basis of the parent company is completely "purified" of the eligible profit distribution as if it had received no profit distribution at all. However, questions may arise when a Member State has chosen a different, more particular approach than a "genuine exemption".

5.015 This is, for instance, the case in Belgium where the participation exemption can be characterized as an "inclusion and deduction" regime: the incoming profit distribution is first included in the taxable basis of the parent company and is only subsequently, after a number of other operations to determine the taxable basis, deducted from the amount of taxable profits still remaining in that operation (the so-called "dividends received deduction" or "DRD"). The case-law of the CJEU makes clear that, whilst not as such being incompatible with Article 4(1)(a) PSD (see *supra*, section B.2.c.i), such alternative system should nevertheless ensure that the same result as a "genuine exemption" is obtained, *viz*. that the incoming profit distribution is not indirectly subject to taxation.

5.016 According to the CJEU, the "litmus test" to determine whether the result of Article 4(1)(a) PSD has been reached in such a case is to compare with a situation where a genuine exemption of the PSD-eligible profits from the taxable basis had been applied or, more broadly, where no PSD-eligible profits had been received by the company.[26] That test can explain the various cases in which the CJEU has ruled that the Belgian participation exemption did not achieve the result required by Article 4(1)(a) PSD:

- In *Cobelfret* and *KBC Bank and Beleggen, Risicokapitaal, Beheer*, at issue was the impossibility to carry-forward unused DRD to subsequent taxable periods. Due to the "inclusion and deduction" regime, a company with a current year operational loss receiving PSD-eligible dividends would have its tax loss of the year (which it can normally carry forward) absorbed by these dividends. The DRD could not be used to that extent and the unused part could not be carried forward. As such, a company receiving PSD-eligible dividends would be worse off than a company that would not. After all, the latter would have a (higher) tax loss that can be carried forward. The CJEU found that this led to indirect taxation of the dividends in a subsequent taxable period where the company would become profitable (and where it would otherwise be able to set-off a carried forward tax loss).[27] In reaction to this case-law, the Belgian legislator allowed for

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26 Case C-389/18 Brussels Securities SA [2019] ECLI:EU:C:2019:1132, § 45; Case C-295/21 Allianz Benelux [2022] ECLI:EU:C:2022:812, § 42. Of course, when making such a comparison, account should be taken of the exercise by the Member State concerned of the option to render the charges linked to the respective participation non-deductible (Article 4(3) PSD, see section D).

27 Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82, para. 39-40.

the unlimited carried forward DRD ("CF DRD") relating to dividends falling within the scope of the PSD.[28]

- In *Brussels Securities,* the CJEU was faced with a complex interaction between the different corporate income tax deductions (including the DRD and CF DRD) and the specific order of application of these tax deductions. The fact that the DRD and CF DRD had to be deducted before a tax deduction that could only be carried forward for a limited period (*in casu* the notional interest deduction carried forward) could lead to a position whereby the latter deduction would be forfeited, whilst this would not have been the case (i) if no dividends were received or (ii) if Belgium had opted to simply exclude the dividend from the taxable base from the outset.[29] On the basis of that reasoning, the CJEU concluded that the "inclusion and deduction" regime, together with the rules on the order of tax deductions, gave rise to prohibited indirect taxation of PSD-eligible dividends.[30]
- In *Allianz Benelux*, the CJEU was asked, in essence, to rule to what extent any CF DRD existing at the level of a company which is absorbed in the context of a tax-neutral merger should be transferred to the absorbing company to allow deduction in future taxable periods in the latter's hands. Under Belgian tax law, carried forward tax losses of the absorbed company are transferred on a proportional basis to the absorbing company (the proportion being determined by the relative (net tax) values of the respective companies). Applying the "litmus test", the CJEU in essence ruled that the Belgian tax authorities should (at least) allow for the same proportional transfer of CF DRD.[31]
- In the *John Cockerill* case,[32] the CJEU came to a similar conclusion. That case concerns another complex interaction between the Belgian participation exemption regime, on the one hand, and the Belgian tax consolidation ("group contribution") regime, on the other hand. Under the Belgian group contribution regime, a qualifying group company can transfer taxable profits towards another qualifying group company by virtue of a (tax-deductible) group contribution, which the latter should include in its taxable base and can be off-set by its (tax-adjusted) accounting losses. Any group contribution received which exceeds the (tax-adjusted) accounting losses constitutes a minimal taxable base, which cannot be absorbed by other tax-specific deductions such as the DRD. Since the receipt of PSD-eligible dividends reduces the (tax-adjusted) accounting losses, companies with operational losses which receive a group contribution from a qualifying group company are treated less beneficially where they, in addition, receive PSD-eligible dividends. Hence, the CJEU decided that the Belgian DRD rules once more violate the provisions of the PSD.

The above "litmus test" is equally useful to determine whether the application of certain additional taxes by Member States, next to general corporate income **5.017**

28 Extended to domestic dividends and dividends of EEA Member States.

29 Case C-389/18 Brussels Securities SA [2019] ECLI:EU:C:2019:1132, § 45.

30 Case C-389/18 Brussels Securities SA [2019] ECLI:EU:C:2019:1132, § 53, 54 and *dictum*.

31 Case C-295/21 Allianz Benelux [2022] ECLI:EU:C:2022:812, § 41 *et seq*.

32 Case C-135/24 John Cockerill [2024] ECLI:EU:C:2025:176.

tax, may violate Article 4(1) PSD. In the *X*, *AFEP* and *Schneider Electric* cases, a specific additional tax levy applying to (parent) companies which (themselves) distribute dividends was considered to violate Article 4(1) PSD, as that tax could be levied on PSD-eligible dividends received by these companies which were redistributed to their shareholders. The receipt of these PSD-eligible dividends thus influenced the taxable base of the company under that additional tax levy, violating Article 4(1) PSD.[33]

5.018 That latter test, in our view, also suggests that Member States that have a progressive corporate tax regime cannot apply a so-called "exemption with reservation of progression" (meaning that the profit distribution received is as such exempted but is nevertheless taken into account to determine the tax rate applicable to other income),[34] as that would mean that the receipt of PSD-eligible dividends has an impact on the tax burden of the parent company.

5.019 Of course, Article 4(1)(a) PSD does not preclude the Member State of the parent company from applying any withholding tax on profit (re-) distributions made by that (intermediate) parent company towards its own parent company (the conditions of Article 5 PSD may have to be observed in that regard).[35]

(ii) Anti-hybrid rule

5.020 Article 4(1)(a) PSD includes an "anti-hybrid" (or "linking") rule, further to which the Member State of the parent company or of its PE is only compelled to provide for an exemption for incoming distributed profits "to the extent that such profits are not deductible by the subsidiary" and should even "tax such profits to the extent that such profits are deductible by the subsidiary".

5.021 This rule was introduced in Article 4(1)(a) PSD by Council Directive 2014/86/EU[36] because the benefits of the PSD "should not lead to situations of double non-taxation and, therefore, generate unintended tax benefits for groups of parent companies and subsidiaries of different Member States when compared

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33 Case C-68/15 X [2017] ECLI:EU:C:2017:379, § 74-82; Case C-365/16 AFEP and Others [2017] ECLI:EU:C:2017:378, § 25-35; Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2022:378, § 49-53.

34 In legal doctrine up until today, it is generally argued that the wording of Article 4(1)(a) PSD does not provide a response as to whether such an "exemption with a reservation of progression" is compatible with such provision (see e.g. G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 20 and, in the same vein, M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 271).

35 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 272.

36 Council Directive 2014/86/EU of 8 July 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, *OJ* 25 July 2014, L 219, 40 ("*Council Directive 2014/86/EU*").

to groups of companies of the same Member State".[37] The anti-hybrid rule, which had to be implemented into national law by 31 December 2015, is hence aimed at ensuring that the (distributed) profits are subject to tax once (single taxation).[38]

A classic example in which such a rule may apply, is the case of a "hybrid loan",[39] which qualifies (i) as a debt instrument in the Member State of the subsidiary company (giving rise to tax deductible interest) and (ii) as an equity instrument in the Member State of the parent company or of its PE (giving rise to an exempt profit distribution).[40] It must be stressed, however, that the anti-hybrid rule applies irrespective of whether the deductibility of the profit distribution is caused by a different characterisation of a financial instrument or for some other reason.[41] **5.022**

Whilst it is not contentious to relieve the Member State of the parent company or of its PE of the obligation to "exempt" in those situations, it is not self-evident to actually require such Member State to "tax" such profits to the extent that they are deductible in the hands of the subsidiary.[42] In this respect, whilst some have observed that the Council is very much allowed to adopt such a rule on the basis of Article 115 TFEU, as cross-border double non-taxation **5.023**

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37 See recital 2 of Council Directive 2014/86/EU.

38 H. Weber-Grellet, 'Mutter-Tochter-RL', in A. Musil & H. Weber-Grellet (eds.), *Europäisches Steuerrecht* (Beck 2022), 353, no. 7. Before the introduction of this rule, it was contested whether the Member States could make the exemption conditional upon whether the profit distribution gave rise to a tax deduction in hands of the subsidiary – see for more details G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 650, no. 14.57.

39 E.g. O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 544.

40 In literature, other examples are given as well, e.g. deductible dividends distributed by certain investment companies. See O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 544-545 and C. Brokelind, 'Legal Issues in Respect of the Changes to the Parent-Subsidiary Directive as a Follow-Up of the BEPS Project' (2015) Intertax, 818-819. Another example cited in literature are deductible profit distributions under the Brazilian interest on net equity regime ("(juros sobre o capital proprio"), to the extent that these can be regarded as "profit distributions" within the meaning of Article 4 PSD (see in respect of the latter, section B.3.b.i). See R. Calvo, E. San Salvador, 'Tax Treatment of JSCPs in Spain: Past, Present and Future' (2017) European Taxation, issue 10, 447; M. Loran and E. Villa, 'Hybrid Mismatches and the BEPS Project: A Spanish Perspective on Brazilian Juros' (2017) *Der. Fin. Instr.* 2017, issue 2, section 3.

41 C. Marchgraber, *Double (Non-)Taxation and EU Law* (Kluwer Law International 2018), 327-328.

42 Moreover, such an obligation to tax may cause potential tax treaty overrides in certain (e.g. triangular) situations, see C. Marchgraber, 'Cross-Border Tax Arbitrage, the Parent-Subsidiary Directive (2011/96) and Double Tax Treaty Law' (2016) Bull. Int. Tax., issue 3, 126-131; G. Kofler, 'EU-Mandated Tax Treaty Overrides' in F. DEBELVA (ed.), *Liber Amicorum Luc De Broe. The Least Taxed Road. Essays at the occasion of Prof. Luc De Broe's emeritus ceremony* (Wolters Kluwer 2024), 291.

appears to be just as problematic for the internal market as cross-border double taxation,[43] others have raised doubts in that regard.[44]

5.024 Be that as it may, it is also not self-evident what the obligation to "tax" entails from a technical perspective. We agree with the view that this (merely) requires that the deductible part of the profit distribution is included in the parent company's taxable base for corporate income tax purposes and that it hence does not require effective taxation of such profit element (in the sense of giving rise to a tax cash impact), for instance where the parent company is in a loss position.[45] Some have furthermore argued that the text of Article 4(1)(a) PSD supports a claim that Member States may even apply a beneficial tax rate to such profits.[46] The anti-hybrid rule applies if the distributed profits "are deductible" in the hands of the subsidiary. The question arises whether this requires an actual tax deduction or whether the mere potentiality of a tax deduction (e.g. the mere characterisation of the payment as – theoretically deductible – interest) suffices. This may be important in the light of rules which partially or entirely exclude deductibility, such as interest limitation rules. Whilst some authors refer to the literal text of the provision to only require a potential tax deduction,[47] most legal scholars refer to the objective of the anti-hybrid rule to avoid situations of double non-taxation and argue in favour of an actual deduction.[48]

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43 H. Weber-Grellet, 'Mutter-Tochter-RL', in A. Musil & H. Weber-Grellet (eds.), *Europäisches Steuerrecht* (Beck 2022), 353, no. 9.

44 E.g. W. Haslehner, 'Anti-Hybrid Measures in the Parent Subsidiary Directive and the EU's Competence to Harmonise', www.kluwertaxblog.com (accessed on 3 October 2024); M. Desens, 'Ist die neue Korrespondenzregel in der Mutter-Tochter-Richtlinie mit dem primären Unionsrecht vereinbar?' (2014) IStR, 828 and C. Kahlenbergh and A. Kopec, 'Vermeidung von Qualifikationskonflikten im Rahmen der Mutter-Tochter-Richtlinie: Plädoyer für eine Legaldefinition des Begriffs der Gewinnausschüttung zur Begrenzung des bestehenden Korrespondenzprinzips' (2016) StuW, 164-165.

45 G. Kofler, 'Hybrid Loans in the Parent-Subsidiary Directive', in P. Valente (ed.), *Elusione Fiscale Internazionale* (Wolters Kluwer Italia 2014), 686 and C. Marchgraber, *Double (Non-)Taxation and EU Law* (Kluwer Law International 2018), 330-333.

46 G. Kofler, 'Hybrid Loans in the Parent-Subsidiary Directive', in P. Valente (ed.), *Elusione Fiscale Internazionale* (Wolters Kluwer Italia 2014), 686. Evidently, this would suppose that that Member State submits other profits distributions received to that beneficial tax rate as well (and not only those targeted by the anti-hybrid rule), as that would otherwise amount to a form of partial exemption of the latter profits. Moreover, that beneficial tax rate would need to be consistent with primary EU law, such as the provisions of Article 107 and 108 TFEU on State aid.

47 F. Schiefer, 'Maßnahmen zur Bekämpfung hybrider Finanzierungsinstrumente' (2015) IWB, 355-356.

48 C. Marchgraber, *Double (Non-)Taxation and EU Law* (Kluwer Law International 2018), 329 and O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 545. See in the same vein also T. Hagemann and C. Kahlenberg, 'Sekundärrechtliche Reaktionen auf aggressive Steuerplanungsaktivitäten – Änderung der Mutter-Tochter-Richtlinie' (2014) IStR, 842-843 as well as C. Kahlenbergh and A. Kopec, 'Vermeidung von Qualifikationskonflikten im Rahmen der Mutter-Tochter-Richtlinie: Plädoyer für eine Legaldefinition

Even if one would require an actual deduction, one may nevertheless wonder whether one should adopt a static or dynamic approach.[49] After all, the non-deductibility in a given taxable period may be a mere timing difference.[50] Strictly requiring an actual deduction may therefore leave situations of double non-taxation (D/NI) intact. Some have therefore argued in favour of a textual interpretation.[51] Alternatively, an in-between solution, which would in our view be in line with the principle of proportionality in the sense of not exceeding what is necessary to achieve the objective of countering double non-taxation, could be to provide for immediate exemption, subject to recapture as soon as and insofar as the sanction of non-deductibility was effectively reversed in the source state. **5.025**

It is important to stress that the tax deduction should in any case be causally linked to the profit distribution for the anti-hybrid rule to apply. General deductions which are linked to equity investments into the subsidiary without being linked to any profit distributions made by that subsidiary, such as "notional interest" deduction regimes[52], are therefore not caught by the anti-hybrid rule.[53] Furthermore, the anti-hybrid rule only applies "to the extent **5.026**

des Begriffs der Gewinnausschüttung zur Begrenzung des bestehenden Korrespondenzprinzips' (2016) StuW,163, who observe that the literal interpretation (of a mere potential deduction) might go against the aim of the PSD and the anti-hybrid rule.

49 In that sense C. Kahlenbergh and A. Kopec, 'Vermeidung von Qualifikationskonflikten im Rahmen der Mutter-Tochter-Richtlinie: Plädoyer für eine Legaldefinition des Begriffs der Gewinnausschüttung zur Begrenzung des bestehenden Korrespondenzprinzips' (2016) StuW, 164.

50 For instance, where the Member State of the subsidiary applies the interest limitation rule of Article 4 ATAD and (in line with Article 4(6) ATAD) allows that the non-deductible interest (exceeding borrowing costs) may be carried forward to future taxable periods.

51 F. Schiefer, 'Maßnahmen zur Bekämpfung hybrider Finanzierungsinstrumente' (2015) IWB, 355-356.

52 These are thus different from regimes that provide for a deduction on net equity involving an actual payment to shareholders (such as the example cited at note 339). This is also consistent with the distinction made under the OECD Recommendations on hybrid mismatches (see OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report (OECD Publishing 2015), 17, para. 11): "The hybrid mismatch rules focus on payments and whether the nature of that payment gives rise to a deduction for the payer and ordinary income for the payee. Rules that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to make a payment, such as regimes that grant deemed interest deductions for equity capital, are economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes in the sense contemplated by Action 2".

53 G. Kofler, 'Hybrid Loans in the Parent-Subsidiary Directive', in P. Valente (ed.), *Elusione Fiscale Internazionale* (Wolters Kluwer Italia 2014), 685; K. Karaianov, 'Notional Interest Deduction Regimes in Europe: Through the Prism of ATAD 2 and Domestic Anti-Hybrid Mismatch Rules' (2019) European Taxation, 481; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 649, no. 14.57. In the same vein: C. Marchgraber, *Double (Non-)Taxation and EU Law* (Kluwer Law International 2018), 329.

that" the profit distribution gives rise to the tax deduction, so that only a partial obligation to tax could arise on the basis of that rule.[54]

5.027 The anti-hybrid rule in Article 4(1)(a) PSD has precedence over the rules regarding hybrid mismatches embedded in the Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries ("ATAD 2").[55] According to the latter's recital 30, "there should be no scope for the application of the hybrid mismatch rules provided for in this Directive" where the PSD's anti-hybrid rule "lead[s] to the neutralisation of the mismatch".[56] Where the latter rule is incapable of addressing the mismatch, the ATAD's rules may (re)gain relevance.[57] This would mean that, if a dynamic (or recapture) approach were to be taken to the application of the PSD anti-hybrid rule (as set out above), there would in principle be no room for the application of the ATAD anti-hybrid rules to the respective payments. Conversely, if the static approach were adhered to, the PSD would be unable to neutralise the potential mismatch, so that recourse should be made to the ATAD anti-hybrid rules in the event of later deductibility of the respective payments in the source state.

(d) Tax credit

(i) Main rule

General aspects

5.028 The use of the tax credit method under Article 4(1)(b) PSD entails the (inclusion in the taxable base and) taxation of the gross amount of the profit distribution received,[58] whilst simultaneously granting an indirect and ordinary tax

54 P. Kavelaars, *International fiscaliteit in transitie* (Stichting NLFiscaal 2017), 80-81. In the same vein G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 649, no. 14.57.

55 OJ 7 June 2017, L 144, 1.

56 See also C. Kahlenberg and S. Radmanesh, 'Artikel 9. Hybride Gestaltungen', in T. Hagemann and C. Kahlenberg, *Anti Tax Avoidance Directive (ATAD) Kommentar* (NWB Verlag 2019), 737-739, nos. 39-41 for a more in-depth discussion of the interplay between the PSD's anti-hybrid rule and the ATAD's anti-hybrid rules and the precedence of the PSD rule.

57 For instance, it is observed in literature that the text of Article 4(1)(a) PSD suggests that the (actual) tax deduction should be applied by the subsidiary company, so that the PSD's anti-hybrid rule cannot be applied where the tax deduction is effectively claimed by another entity (e.g. in the context of a tax consolidation regime) (G. Maisto, 'EU and OECD Convergence on International Tax Standards – Focus on Aggressive Tax Planning and Its Foreseeable Future Developments', in R. Danon (ed.), *Base Erosion and Profit Shifting (BEPS): Impact for European and international tax policy*, (Schulthess 2016), 186. In that context, the ATAD's anti-hybrid rules could be applied.

58 That is, including the amount of tax – see G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 23 and G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 652, no. 14.61.

credit for the foreign taxes on these distributed profits paid at the level of the subsidiary. Since the amendment of the PSD in 2003,[59] a similar credit must equally be granted for taxes paid at the level of all lower-tier subsidiaries with regard to the same distributed profits, provided that these equally qualify as a "company of a Member State" and as a "subsidiary" in the sense of Articles 2 and 3 PSD [Chapter 4].

The objective of the credit method is to prevent the imposition of a series of tax charges on distributed profits.[60] Consequently, use of that method requires that the amount of foreign tax can be credited in full against the domestic corporate tax.[61] However, Article 4(1)(b) PSD only requires an ordinary credit and no full credit,[62] since the amount of the required credit is limited to "the amount of the corresponding tax due" by the parent company upon receipt of the profit distribution. Member States with a lower rate of tax than the foreign taxes paid are not required to allow excess foreign tax credits to be deducted against domestic tax on other income than the profit distribution received,[63] nor to provide for a carry-forward or carry-back of any "excess" foreign tax credits.[64] **5.029**

59 Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, *OJ* 13 January 2004, L 7, 41. This directive should have been implemented by the Member States by 1 January 2005 at the latest.

60 Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774, § 104.

61 *Ibid*.

62 Case C-27/07 Banque Fédérative du Crédit Mutuel [2008] ECLI:EU:C:2008:195, § 25; Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774, § 44 and 102.

63 P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 269 and O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 545.

64 G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 27 and G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 652, no. 14.61. In the same vein: O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 546.

Object and timing of the tax credit

5.030 A tax credit must only be granted in proportion to "[the] fraction of the corporation tax related to those profits and paid by the subsidiary and any lower-tier subsidiary".[65,66]

5.031 On account of the EU fundamental freedoms and since reference is merely made to the companies (subsidiaries) paying the corporation tax, the creditable foreign tax should not be limited to the taxes levied by the Member State of the subsidiary, but also include taxes levied by other Member States (e.g. on profits of an EU permanent establishment of the subsidiary, even if those profits are exempt in the Member State of the subsidiary based on a tax treaty).[67]

5.032 The question arises whether those taxes must have been effectively paid first, before giving rise to a tax credit in the hands of the parent company. Under the original version of the PSD (Directive 90/435/EEC), it has been argued that this should not be a requirement, since (i) some language versions of Article 4(1) PSD did not impose such a condition and (ii) holding otherwise would be contrary to the objective of the PSD, in the light of the differences in periods during which taxes are determined and levied across the Member States.[68] However, unlike Article 4(1) of the original version of the PSD, current Article 4(1)(b) PSD refers, in most language versions, to tax that "is paid" (past tense).[69] In theory, it does seem technically possible to apply such a

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65 Note that there exist differences in certain other language versions. The Dutch and German language versions, for example, refer to "all taxes" (Dutch: "*iedere belasting*"; German: "*alle Steuern*" in Recital 11 of the PSD and "*den Steuerteilbetrag*" in Article 4). This may be the reason why certain scholars were also prompted to ask whether a credit is only available for the listed taxes ("*in which case why not say so*") and whether local taxes may also be considered (see J.D.B. Oliver, 'The Parent-Subsidiary Directive of 23 July 1990: A United Kingdom perspective' (2001) EC Tax Review, 216).

66 Under former Article 5 of the original version of the PSD (Directive 90/435/EEC), certain Member States had a temporary right to maintain certain withholding taxes on distributions falling under the PSD. In such cases, pursuant to former Article 4(1) of the original version of the PSD, the tax credit granted in the parent state had to include these withholding taxes (see also Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82, § 30; Case C-27/07 Banque Fédérative du Crédit Mutuel [2008] ECLI:EU:C:2008:195, § 25; Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774, § 44 and 102).

67 M. Tenore, 'Taxation of Dividends: A Comparison of Selected Issues under Article 10 OECD MC and the Parent-Subsidiary Directive' (2010) Intertax, issue 4, 236 and G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 25.

68 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 276.

69 This difference can, for example, be observed in the Dutch language version which, under the initial version of the former PSD, merely referred to the "tax of the subsidiary" ("*de belasting van de dochteronderneming*") and, since the amendment thereof in 2004, additionally refers to the tax which is "paid" by that subsidiary" ("*betaald is door de dochteronderneming*").

condition of prior payment of foreign tax in a manner which is consistent with the PSD.[70]

Next to the former question, Article 4(1)(b) PSD does not provide any further details as regards the taxable period during which the tax credit should be granted either. This can therefore be freely determined by the Member States.[71] In practice, the tax credit is often granted and applied in respect of the taxable period during which the profit distribution was received by the parent company.[72] **5.033**

In addition to not providing unequivocal guidance on which types of foreign taxes should give rise to a tax credit,[73] the text of Article 4(1)(b) PSD leaves it up to the Member States to determine the method or form of granting the tax credit. In that respect, it has been argued that the Member States are free to choose between applying an "overall limitation" or a "per-country limitation", a system under which no tax credit is available insofar as the foreign taxes paid in one single other EU Member State exceed the amount of corporate tax due in the Member State of the parent on (that part of) the profit distribution received from a subsidiary in that other EU Member State.[74] **5.034**

Article 4(1) PSD also does not deal with the impact of currency exchange gains or losses, nor the formal conditions[75] that need to be observed for claiming the credit.[76] Such issues are therefore governed by national law (or tax treaty law). **5.035**

70 This could for example be achieved by a carry-back of that tax credit to the tax paid by the parent company in the previous taxable period (and reimbursement thereof) once the foreign tax has been paid by the subsidiary (see in respect of the timing of the granting of the tax credit also *infra*).

71 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 275.

72 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 275. In such cases, Member States will have to observe whether the foreign tax(es) will actually be paid by the subsidiary.

73 See *supra*, footnote 65.

74 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 275.

75 However, these formal conditions must be sufficiently enacted in positive national law provisions. Merely requiring taxpayers to claim relief through administrative or legal appeals therefore does not suffice (see in that sense Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2022:378, § 60-61 – see also *infra* section B.4).

76 G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 652, no. 14.61. See also (for some aspects), M. Tenore, 'The Parent-Subsidiary Directive', in M. Lang et al. (eds.), *Introduction to European Tax Law on Direct Taxation* (Linde 2024), 150, no. 410.

5.036 Finally, that provision, as such, does not oblige a Member State to already take into account the application of the tax credit in the context of a regime of advance corporate income tax payment.[77]

(ii) No anti-hybrid rule

5.037 Unlike the exemption method (see section B.2.c.ii), no explicit anti-hybrid rule has been provided under the credit method in Article 4(1)(b) PSD. In literature, this has been explained by the fact that the latter provision already (implicitly) contains such a linking rule. Since the tax credit to be granted by the parent state is in first instance limited to the corporation tax paid by the subsidiary related to the distributed profits, no credit should be granted where the distributed profits are tax deductible for the subsidiary.[78]

5.038 However, as mentioned, the Member State of the parent company must also grant a credit for any corporation tax paid by a lower-tier subsidiary on the same profits. It has been pointed out in literature that this may lead to a difference in treatment between the credit and exemption methods in the case of payments on hybrid instruments. If a lower-tier subsidiary A has paid corporation tax on profits distributed to a subsidiary B (where they benefit from relief from double taxation under Article 4(1) PSD) and these profits are subsequently transferred by subsidiary B to the parent company C by means of a deductible payment under a hybrid instrument, the state of parent company C (applying the credit method) may still have to grant a tax credit for the taxes paid by lower-tier subsidiary A (even though subsidiary B benefits from a deduction which may already "cancel out" any double taxation). Conversely, if the Member State of parent company C were to apply the exemption method, the deduction by subsidiary B is de facto (by virtue of the anti-hybrid rule) considered to "cancel out" double taxation, so that such a Member State is obliged to tax (and may not grant any relief).[79]

77 Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774, § 105. However, under the influence of the fundamental freedoms, a Member State may not discriminate in this regard against foreign subsidiaries if it does take these rules into account with regard to domestic subsidiaries (*ibid.*, § 156-157).

78 C. Kahlenberg and A. Kopec, 'Hybrid Mismatch Arrangements – A Myth or a Problem That Still Exists?' (2016) World Tax Journal, issue 1, 69-70.

79 See I. De Groot, 'Exemption Method in the EU Parent-Subsidiary Directive Amended in Respect of Hybrid Instruments: What about the Credit Method?' (2015) EC Tax Review, issue 3, 159-164.

3. Scope of application

(a) Introduction

Relief for economic double taxation should only be provided for "distributed profits" (see *infra*, section B.3.b) which are received by the parent company or its PE "by virtue of the association of the parent company with its subsidiary" (see *infra*, section B.3.c). **5.039**

Reference is made to the chapter on Article 3 PSD [Chapter 4] for the conditions that should be met for a company to qualify as a "parent company" or "subsidiary" for the purposes of the PSD, including Article 4(1). In addition, reference is made to the chapter on Article 1 PSD [Chapter 2] in respect of the condition that the distribution of profits must have a "cross-border", "intra-EU" character, in the sense of occurring from a company of a Member State to a company of another Member State (or to a PE of a company of a Member State, situated in a Member State other than the Member State of the subsidiary). **5.040**

(b) Profit distribution

(i) General aspects

The concept of a "profit distribution" is not defined in the PSD (see also Article 1 PSD) [Chapter 2]. The use of the notion of a "profit distribution" instead of "dividends", makes clear that that notion is broader than the mere "dividend" notion.[80] **5.041**

For the remainder, the question arises whether the notion has an autonomous EU law meaning or should be interpreted on the basis of the national laws of (one of) the EU Member States. According to most authors, the notion should be given an autonomous meaning that is (in principle) distinct from the meaning that it may have under the national (tax or other) legislation (or tax treaties) of the Member State of the parent company.[81] This is in line with (i) **5.042**

80 M. Helminen, 'Dividend equivalent benefits and the concept of profit distribution of the EC Parent-Subsidiary Directive' (2000) EC Tax Review, issue 3, 162; W. Kessler, 'Weiterentwicklung des Deutschen und Internationalen Steuerrechts - Teil I' (2004) IStR, 814 and M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 65. In a similar vein: G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri"' (1992) Rivista di diritto tributario, 558; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 640, no. 14.41 and L. De Broe and R. De Boeck, 'De Moeder-dochterrichtlijn: Europese fiscale piecemeal engineering op weg naar harmonie', in B. Peeters (ed.), *Europees belastingrecht* (Larcier 2005), 401, no. 86.

81 M. Helminen, 'Dividend equivalent benefits and the concept of profit distribution of the EC Parent-Subsidiary Directive' (2000) EC Tax Review, issue 3, 162; M. Helminen, *The International Tax Law*

the general interpretative rule that, where no reference is made to the domestic law of the EU Member States, concepts employed in EU law normally have an autonomous meaning distinct from the meaning that they have under the national laws of the Member States[82] and (ii) the fact that such autonomous meaning would be in line with the aim of the PSD to relieve economic double taxation.[83]

5.043 In accordance with legal doctrine, that autonomous notion of a "profit distribution" would cover all transfers of assets or of any value to a parent company at the expense of the subsidiary (i.e. for no equivalent value or benefit in exchange).[84] This of course includes dividends (in cash or in kind[85]), irrespective of whether they are distributed proportionally to the shareholders or not.[86] However, the notion may also include other items of income which bear resemblance to dividends. Of course, the other condition(s) of Article 4(1) PSD (see *infra*, section B.3.c) need to be fulfilled as well, which means that in practice, some of those items of income ultimately do not fall within the purview of Article 4(1) PSD (see *infra*, section B.3.d, for a more elaborate account and an analysis).

Concept of Dividend (Kluwer Law International 2017), 65; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 640, no. 14.42; J. Kokott, *EU Tax Law* (Beck, 2022), 377, no. 43 and O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 551. In a similar vein: P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 272-273 and G. Maisto, 'Current Issues on the Interpretation of the Parent-Subsidiary Directive', in D. Weber and G. Maisto (eds.), *EU Income Tax Law: Issues for the Years Ahead* (IBFD 2013), 16-171. Seemingly *contra*: P. Dibout, 'La directive communautaire du 23 juillet 1990 relative au régime fiscal commun applicable aux sociétés mères et filiales d'états membres différents' (1991) Droit Fiscal, étude 100007, no. 25 and D. Berlin, *Politique fiscale, Vol. II, Commentaire J. Mégret* (Éditions de l'Université de Bruxelles 2012), 257, no. 1386.

82 See *e.g.* Case C-656/19 BAKATI PLUS [2020] ECLI:EU:C:2020:1045, § 38 (VAT Directive); Case C-327/82, Ekro [1984] ECLI:EU:C:1984:11, § 11. See also K. Lenaerts and J.A. Gutiérrez-Fons, *Les méthodes d'interprétation de la Cour de justice de l'Union européenne* (Bruylant 2020), 23 et seq.

83 See *e.g.* M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 65-66 and M. Odar and B. Pate, 'Taxation of Cross-Border Hidden Profit Distributions: (In)correct Implementation of the Parent-Subsidiary Directive in Slovenia?' (2012) European Taxation, issue 12, 582.

84 See e.g. M. Helminen, 'Dividend equivalent benefits and the concept of profit distribution of the EC Parent-Subsidiary Directive' (2000) EC Tax Review, issue 3, 162; M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 65-66; O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 550.

85 E.g. F. Vanistendael, 'The implication of the Parent/Subsidiary Directive in the EC – Comments on some unresolved questions' (1992) Tax Notes International, 604; M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 269 and G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 641, no. 14.42.

86 G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 641, no. 14.42.

Nevertheless, it is clear that the definition of a "profit distribution" cannot function completely independently from domestic laws of the Member States.[87] To determine whether there has been an actual transfer of any value (profits) (by virtue of a shareholder relationship, see section B.3.c.i), the commercial law[88] and/or tax law of the Member States may still be relevant.[89] **5.044**

(ii) Excluded items

Capital gains on shares

It is clear that the notion of "distributed profits" does not cover (realised or unrealised) capital gains on shares.[90] **5.045**

Reimbursements of paid-up capital

Reimbursements of paid-up capital (e.g. in the context of a capital reduction) are equally out of scope of Article 4(1) PSD,[91] since these do not concern the distribution of "profits", but mere reimbursements of the equity contribution to the shareholder.[92] Conversely, reimbursements, by means of a capital **5.046**

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87 M. Helminen, 'Dividend equivalent benefits and the concept of profit distribution of the EC Parent-Subsidiary Directive' (2000) EC Tax Review, issue 3, 162; L. De Broe and R. De Boeck, 'De Moederdochterrichtlijn: Europese fiscale piecemeal engineering op weg naar harmonie', in B. Peeters (ed.), *Europees belastingrecht* (Larcier 2005), 401, no. 86 (note 137); C. Kahlenberg and A. Kopec, 'Hybrid Mismatch Arrangements – A Myth or a Problem That Still Exists?' (2016) World Tax Journal, issue 1, 68-69; M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 65; J. Bundgaard, *Hybrid Financial Instruments in International Tax Law* (Wolters Kluwer 2017), 189 and 192; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 643, no. 14.45. In a similar vein: O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 551-552.

88 In *Les Vergers du Vieux Tauves*, the CJEU for example looked at Belgian civil law to determine whether the beneficiary company received a distribution by virtue of the association with its subsidiary (within the meaning of Article 4(1) PSD – see further section B.3.c.ii.), see Case C-48/07 Les Vergers du Vieux Tauves [2008] ECLI:EU:C:2008:758, § 32 and 41. See also G. Maisto, 'Current Issues on the Interpretation of the Parent-Subsidiary Directive', in D. Weber and G. Maisto (eds.), *EU Income Tax Law: Issues for the Years Ahead* (IBFD 2013), 11-13 and 15-17.

89 As an example, the national laws of the EU Member States may differ on the question of whether bonus shares are considered distributions of profits. Only when this is effectively the case would bonus shares be covered by Article 4(1) PSD, see in that vein: M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 142-145.

90 See *ex multis* F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 431; D. Berlin, *Politique fiscale, Vol. II, Commentaire J. Mégret* (Éditions de l'Université de Bruxelles 2012), 257, no. 1386; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 642, no. 14.42 and O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 549.

91 See also F. Vanistendael, 'The implication of the Parent/Subsidiary Directive in the EC – Comments on some unresolved questions' (1992) Tax Notes International, 606.

92 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 269 and G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 642, no. 14.42.

reduction, of retained earnings that were previously incorporated into the equity capital, should qualify as a profit distribution.[93]

Liquidation gains

5.047 Article 4(1) PSD explicitly excludes profits received by the parent company (or its PE) in connection with the liquidation of the subsidiary from its scope of application. This exclusion, which is opposed to the initial (1969) proposal for a directive[94] and does not feature in Article 5 PSD,[95] is supported by various explanations in legal doctrine:

- Such exclusion is in line with the aim of the PSD, which is to facilitate cross-border concentrations between companies of different Member States and which would not be served by the unwinding of concentrations or the liquidation of companies.[96]
- Liquidation gains are, in fact (or at least in accordance with the tax laws of several EU Member States), to be qualified as capital gains, to which the PSD does not extend.[97]

93 In that sense, G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 642, no. 14.42. However, earlier authors argued against the inclusion of these amounts, see J. Malherbe, *Droit fiscal international* (Larcier 1994), 146-148; B. Peeters, 'De Europese moeder-dochter richtlijn', in A. Bax et al. (eds.), *Dividenden zonder grenzen. De moeder-dochterrichtlijn en haar uitvoering in België en de haar omringende landen* (Biblo 1991), 89.

94 See Article 4 of the Proposal for a Council Directive on the Common System of Taxation Applicable to Parent Companies and their Subsidiaries of Different Member States, COM(69) 6 final, OJ 22 March 1969, C 39, 7, which referred to "*les bénéfices distribués […], même à l'occasion de la liquidation de celle-ci*" / « *[d]ie ausgeschütteten Gewinne, […] selbst bei deren Liquidierung*" / "*[g]li utili distribuiti […], anche in occasione della liquidazione di questa*" / "*[d]e uitgekeerde winst […], zelfs bij liquidatie van de dochteronderneming*".

95 Consequently, Article 5 PSD does equally apply to liquidation distributions, see e.g. G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 641-643, no. 14.42-14.44.

96 F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 432; G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 561; C. Harris, 'The European Community's Parent-Subsidiary Directive' (1992) Florida Journal of International Law, 137; O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 110; O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 552.

97 F. Vanistendael, 'The implication of the Parent/Subsidiary Directive in the EC – Comments on some unresolved questions' (1992) Tax Notes International, 605-606; P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 273 and O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 110. See in the same vein: G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 561 and G. Maisto, 'Current Issues on the Interpretation of the Parent-Subsidiary Directive', in D. Weber and G. Maisto (eds.), *EU Income Tax Law: Issues for the Years Ahead* (IBFD 2013), 15-17. Certain authors have added that these profits generally benefit from beneficial tax treatment in the Member State of the parent company, so that additional relief under the PSD would be less important, see O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive',

The latter is perhaps the most convincing argument to explain the difference in wording between Articles 4 and 5 PSD. Certain authors have pointed out, at the time of the inception of the PSD, that the position on the characterisation of liquidation gains often differed depending on the perspective taken. Whilst the residence state of the shareholder could opt for the more "classic"[98] characterisation as capital gains (taxable in the residence state under most double tax conventions), the source state could be inclined to opt for the taxation as a dividend, as that would imply a (limited) taxing right under the existing double tax treaties. The PSD would then only aim to target the latter situation.[99] **5.048**

The notion of liquidation is not defined in the PSD. According to the CJEU, the dissolution of a company, without going into liquidation, such as in the context of a merger within the meaning of the EU Tax Merger Directive, is not a "liquidation".[100] Consequently, a Member State (in the case at hand, Belgium) should grant the benefits of Article 4(1) PSD to a (qualifying) parent company which absorbs a (qualifying) subsidiary in the context of a (silent) merger, even though that operation gives rise to a *deemed* liquidation of the subsidiary for domestic tax purposes. **5.049**

The question nevertheless remains as to which moment a "liquidation" within the meaning of Article 4(1) PSD occurs. Early legal doctrine argued that only distributions made after the commencement of liquidation proceedings should be considered "liquidation" distributions.[101] More recent doctrine goes a step further, arguing that any distribution occurring prior to the formal closure of the liquidation proceedings should not be considered "liquidation" distributions, so that only true liquidation gains are excluded from the benefit of Article 4(1) PSD.[102] **5.050**

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in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 111.

98 See G. Van Fraeyenhoven, 'General report' in IFA, *Cahiers de Droit Fiscal International - Vol. 72b: Tax problems of the liquidation of corporations* (Kluwer 1987), 55, para. 90.

99 See B. Peeters, 'De Europese moeder-dochter richtlijn', in A. Bax et al. (eds.), *Dividenden zonder grenzen. De moeder-dochterrichtlijn en haar uitvoering in België en de haar omringende landen* (Biblo 1991), 101-102; F. Vanistendael, 'The implication of the Parent/Subsidiary Directive in the EC – Comments on some unresolved questions' (1992) Tax Notes International, 605; J. Malherbe, *Droit fiscal international* (Larcier 1994), 146-147.

100 Case C-371/11 Punch Graphix [2012] ECLI:EU:C:2012:647, § 37.

101 F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 432; R. Boon and M. Lambooij, 'EC Parent-Subsidiary Directive: Steps Towards Harmonization of Direct Taxes' (1994) Tax Planning Int'l Rev., issue 6, 9; G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 561 and P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 269.

102 G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 642, no. 14.43 (but see already M. Tumpel, *Harmonisierung der direkten*

5.051 We can side with the latter view, in the light of (1) the fact that the CJEU has also taken a seemingly formalistic approach with regard to interpreting the notion of "liquidation"[103] and (2) the abovementioned (perceived) *ratio legis* of the exclusion of liquidation gains, considering that profit distributions made prior to the closure of the liquidation are generally not to be considered capital gains.

5.052 Certain Member States may provide that a company would be partially liquidated, e.g. upon the exit or death of a shareholder in a closely-held corporation. These partial liquidations would also be excluded "liquidation gains".[104]

Share redemptions

5.053 It has been argued by most authors that gains from (disproportionate) share redemptions are also excluded since (1) these are, in principle, capital gains in the hands of the shareholder and (2) there is little difference between (disproportionate) share redemptions (which are, in fact, a form of partial liquidation) and liquidation distributions which are also excluded from Article 4(1) PSD (see section B.3.b.ii).[105]

5.054 Others have nevertheless argued in favour of the inclusion of share redemptions within the scope of Article 4(1) PSD. To support their claim, reference is made to the fact that, by virtue of EU law (see current Article 60(1)(b) of Directive 2017/1132), share redemptions must stem from a company's distributable profits (net assets).[106] Additional arguments are that:

- in the case of share redemptions, the subsidiary is not actually liquidated (as seems to be required by Article 4(1) PSD);
- the exclusion of liquidation gains from Article 4(1) PSD was a political compromise which cannot be used as an argument for interpreting the exclusion of

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Unternehmensbesteuerung in der EU (Verlag Österreich 1994), 268).

103 Looking at the legal definition of "merger" in the EU Tax Merger Directive (implying a dissolution "without going into liquidation"), see Case C-371/11 Punch Graphix [2012] ECLI:EU:C:2012:647, § 33-34.

104 B. Peeters, 'De Europese moeder-dochter richtlijn', in A. Bax et al. (eds.), *Dividenden zonder grenzen. De moeder-dochterrichtlijn en haar uitvoering in België en de haar omringende landen* (Biblo 1991), 89.

105 F. Vanistendael, 'The implication of the Parent/Subsidiary Directive in the EC – Comments on some unresolved questions' (1992) Tax Notes International, 606; J. Malherbe, *Droit fiscal international* (Larcier 1994), 147-148; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 642, no. 14.42.

106 B. Peeters, 'De Europese moeder-dochter richtlijn', in A. Bax et al. (eds.), *Dividenden zonder grenzen. De moeder-dochterrichtlijn en haar uitvoering in België en de haar omringende landen* (Biblo 1991), 89. This is why certain countries assimilate these gains to dividend income (see also § 28 Commentary on Article 10 OECD Model Income Tax Convention and § 31 Commentary on Article 13 OECD Model Income Tax Convention) and include these in their domestic participation exemption.

liquidation distributions broadly so as to include different forms of partial liquidations; and

- one of the underlying rationales for excluding liquidation gains, namely that such gains do not facilitate the cross-border grouping together of companies, does not bear so much relevance in respect of share redemptions.[107]

In our view, share redemptions are, in most cases, not to be assimilated to liquidation gains. This is true when the repurchased shares are not annulled but remain on the balance sheet of the company or are repurchased with a view to transferring them to a different party. Only where the shares are repurchased followed by their (quasi-) immediate annulment could a potential parallel be made with the exclusion of liquidation gains. Nevertheless and, more fundamentally, it could be argued that the distribution to the shareholder resulting from the redemption of its shares does not fall under the general definition of "profit distribution" as advanced *supra* (section B.3.b.i.) in the sense of a transfer of value for which no equivalent value or benefit has been received in exchange. If the shares are redeemed at their fair market value, the subsidiary receives, in exchange for the distribution to the shareholder, proper shares for an equal countervalue. Consequently, there would be no profit distribution within the meaning of Article 4(1) PSD. This would only be different, in our view, if the shares are redeemed at a value exceeding their market value. In such cases, the excess could constitute a profit distribution. Admittedly, this would make the application of the PSD to share redemptions fairly complex. **5.055**

(c) Received by a parent company or its PE by virtue of its association with its subsidiary

(i) General aspects

The profit distribution must be received by a qualifying "parent company" or by its "permanent establishment". These terms have the meanings assigned to them by Article 3(1)(a) *juncto* 2(a) PSD resp. Article 2(b) PSD [Chapter 4]. It follows from Article 1(1) PSD that these should be established in a different Member State than the distributing subsidiary.[108] **5.056**

107 See M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 230 (albeit without taking any clear position with respect to the inclusion of share redemptions within the scope of Article 4(1) PSD).

108 Of course, nothing in Article 4(1) PSD (or in the other provisions of the PSD for that matter) precludes the Member States from extending the legal consequences required by that provision to dividend distributions between domestic companies (see e.g. Joined Cases C-439/07 and C-499/07 KBC Bank, Beleggen, Risicokapitaal, Beheer [2009] ECLI:EU:C:2009:339, § 57-60).

5.057 Furthermore, in order to be eligible for relief from economic double taxation, the profit distribution should be received by the parent company or its PE "by virtue of the association of the parent company with its subsidiary". This makes clear that only distributions (in cash or in kind) which are "causally attributable" to the shareholding relationship are covered by Article 4(1) PSD[109] (see also further *infra* at section B.3.c.ii).[110]

(ii) Specific issues

Usufruct holders

5.058 It has been discussed that Article 4(1) PSD requires that the profit distribution be received by the parent company "by virtue of the association of the parent company with its subsidiary". Consequently, payments received by mere virtue of a usufruct on the shares in a company are not covered by Article 4(1) PSD.[111]

Profit participating rights and equity derivatives

5.059 By the same token, and contrary to Article 10 of the OECD Model Tax Convention, profit distributions to holders of profit participation rights, founders' rights or other rights which entitle the holder to a part of the profits do not fall within the scope of Article 4(1) PSD.[112] The same is true for income derived from equity derivatives.[113]

(iii) Dividend transfers, stock lending and financial collateral agreements

5.060 The transfer by a shareholder of the right to receive a dividend (a "dividend transfer"), without the transfer of the underlying shares, does not result in

109 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 266; G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 2 G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 644, no. 14.47. In the same vein: O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 108.

110 See, for example, from a French perspective: Conseil d'État 12 April 2019, no. 410315, ECLI:FR:CECHR:2019:410315.20190412, in which reference was made to sums arising from rights attached to shares in the capital of the subsidiary ("*leur perception procède, pour leur montant total, des droits attachés aux titres de participation détenus par la société mère*").

111 Case C-48/07 Les Vergers du Vieux Tauves [2008] ECLI:EU:C:2008:758, § 41 (with regard to the predecessor of current Article 4(1) PSD).

112 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 267; G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 2; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 645, no. 14.48.

113 M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 124; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 645, no. 14.48.

the buyer of the dividend rights (and recipient of the dividend) being able to claim the benefits of Article 4(1) PSD, since the latter requires that the profit distribution be received by a (qualifying) parent company by virtue of the association with its subsidiary.[114] This conclusion holds, even if the buyer of the dividend right was a (qualifying) parent company in relation to the distributing subsidiary to begin with.[115]

As far as stock lending is concerned, most doctrine is of the view that the borrower (and not the lender) could benefit from Article 4(1) PSD (if the other conditions of the PSD are fulfilled), as stock lending transactions generally imply a transfer of the title of ownership of the shares to the borrower, during the term of the agreement.[116] Having regard to the judgment of the CJEU in *Les Vergers du Vieux Tauves*, such a title transfer seems a *conditio sine qua non* for the recognition of the status of "shareholder".[117] Consequently, the same would be true for "title transfer financial collateral agreements".[118] **5.061**

On the other hand, Article 4(1) PSD does not apply to the substitute or manufactured dividend paid by the borrower to the lender, even if the latter would be a (qualifying) parent company vis-à-vis the borrower, since that substitute payment is not made by virtue of the association of the parent company with its subsidiary, but on account of the stock lending agreement.[119] **5.062**

(iv) Partnerships

It is debated as to whether a profit distribution made to a parent company of a Member State which holds a qualifying participation in a company of another Member State via a partnership which is considered tax transparent by all States involved should be granted the benefits of the PSD. After all, according to the company laws of some Member States, the partnership (and not the partner(s)) will, in such case, be registered as the (formal) shareholder in the company's shareholders' register. **5.063**

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114 M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 102; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 645, no. 14.48.

115 *Ibid.*

116 M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 111; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 645, no. 14.48.

117 Case C-48/07 Les Vergers du Vieux Tauves [2008] ECLI:EU:C:2008:758, § 41; see section B.3.c.ii.

118 Within the meaning of Article 2(1)(b) Financial Collateral Directive (Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements).

119 M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 111-112.

5.064 It has indeed been argued in literature that dividends earned for tax purposes by a parent company holding a stake in a subsidiary company via a tax-transparent partnership do not fall within the purview of Article 4(1) PSD.[120] However, the majority opinion seems to be that – following a more "tax-based" reasoning based on the income attribution rules of the States involved – such types of constellations generally fall within the purview of the PSD, with the companies that are partners in the partnership being considered to hold a participation in the underlying subsidiary company directly (and to the same extent as their share in the partnership).[121] On that basis, a similar reasoning could be followed with regard to the reference to the receipt of distributed profits "by virtue of the association of the parent company with its subsidiary".

5.065 According to the majority doctrine, the situation would only be different (1) if the partnership gives rise to a PE in the same Member State as the distributing subsidiary company or (2) if the partnership is located in a third country.[122]

(d) Contentious items

(i) Deemed profit distributions

From the perspective of the Member State of the subsidiary

5.066 As already discussed, whilst the notion of "profit distribution" should in principle be defined autonomously as covering all transfers of assets or of any value to a parent company at the expense of the subsidiary (i.e. for no equivalent value or benefit in exchange), such notion cannot function completely independently from the domestic laws of the Member States (see *supra*, section B.3.b.i).

5.067 On that basis, many authors have argued that the notion of "profit distribution" may even cover payments which are deemed to constitute profit distributions under the domestic tax laws of the Member States. In this respect, reference is

120 M. Tenore, 'Taxation of Dividends: A Comparison of Selected Issues under Article 10 OECD MC and the Parent-Subsidiary Directive' (2010) Intertax, issue 4, 228 and 229. This conclusion applies, according to that author, even if the partnership may be regarded as a permanent establishment in the Member State in which it is located. In support of his position, the author refers to a judgment of the Warsaw District Administrative Court of 5 February 2008 (case no. III SA/Wa 1587/07) (as discussed in F. Świtała, 'Holding Via a Partnership Ineligible for Exemption under the EC Parent-Subsidiary Directive' (2009) European Taxation, issue 7, IBFD Online. This case, however, concerned the application of Article 5 PSD; Poland being the Member State of the subsidiary company which was held by a Dutch BV through a German limited partnership (KG)).

121 See for that conclusion and ample references to supporting legal doctrine, G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 634, no. 14.33.

122 G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 634, no. 14.33.

most often made to rules of the Member State of the subsidiary, such as thin capitalization rules or transfer pricing rules,[123] and it is generally claimed that where that Member State deems an item of income to be a profit distribution, it is self-bound to observe Article 5 PSD ("autolimitation").[124]

For the purposes of the present chapter, however, the question arises whether a deemed dividend resulting from the application of the domestic law of the Member State of the subsidiary which triggers the application of Article 5 PSD also has an impact on the obligations of the Member State of the parent company under Article 4(1) PSD. In this respect, most legal doctrine considers that the legal (tax) fiction applied by the Member State of the subsidiary to consider an item of income as a dividend is not binding upon the Member State of the parent company for the purposes of Article 4(1) PSD.[125] **5.068**

The latter view can be supported for a number of reasons. **5.069**

First, the PSD lacks any rule or principle compelling the Member State of the parent company to follow the (tax) characterisation made by the Member State of the subsidiary.[126] Imposing such an obligation onto the Member State of the parent company would (therefore) be an illegitimate intrusion into the tax sovereignty of the latter. **5.070**

Second, whilst the autonomous EU law notion of a "profit distribution" (see section B.3.b.i) is referred to in both Article 4 and 5 PSD and would in an **5.071**

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123 See e.g. M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 65 and 214; M. Tenore, 'Taxation of Dividends: A Comparison of Selected Issues under Article 10 OECD MC and the Parent-Subsidiary Directive' (2010) Intertax, issue 4, 228; G. Maisto, 'The 2003 amendments to the EC Parent-Subsidiary Directive: what's next?' (2004) EC Tax Review, issue 4, 177-178; P. Dibout, 'La directive communautaire du 23 juillet 1990 relative au régime fiscal commun applicable aux sociétés mères et filiales d'états membres différents' (1991) Droit Fiscal, étude 100007, no. 24.

124 See *i.a.* P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 272-273; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 643-644, no. 14.45-14.46.

125 F. Vanistendael, 'The implication of the Parent/Subsidiary Directive in the EC – Comments on some unresolved questions' (1992) Tax Notes International, 604; G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 558-559; P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), xx; M. Helminen, 'Classification of Cross-Border Payments on Hybrid Instruments' (2004) Bull. Int. Fisc. Doc., 61; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 644, no. 14.46. In the same vein: O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 550-551.

126 O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 551. In the same vein: F. Vanistendael, 'The implication of the Parent/Subsidiary Directive in the EC – Comments on some unresolved questions' (1992) Tax Notes International, 604.

ideal world be interpreted consistently by the Member State of the parent company and of the subsidiary, the scope of application of Articles 4(1) and 5 PSD does not (entirely) coincide.[127] There is a textual argument underpinning such diverging scope: unlike Article 5 PSD, the text of Article 4 PSD requires the profit distribution to be earned by the parent company "by virtue of the association [. . .] with its subsidiary".[128] On that basis, many scholars have contended that Article 4 PSD does not apply to deemed dividends resulting from the application of transfer pricing or thin capitalisation provisions of the Member State of the subsidiary.[129]

5.072 Finally, whilst it is reasonable to consider that the Member State is bound to observe Article 5 PSD when it applies domestic (anti-avoidance) rules resulting in the recognition of a deemed dividend,[130] since (1) it cannot have the best of both worlds by not so classifying the income as a dividend for the purposes of Article 5 PSD and (2) inclusion in Article 5 PSD would serve the aim of the PSD of avoiding double taxation whilst not undermining the effectiveness of the domestic anti-avoidance rule,[131] the same cannot be said from the perspective of the Member State of the parent company.

From the perspective of the Member State of the parent company

5.073 The question arises whether, similar to the Member State of the subsidiary, a principle of "autolimitation" applies to the Member State of the parent company, which entails that it is bound to observe Article 4 PSD to all deemed dividends resulting from the application of its *own* – and hence not the source State's – domestic tax provisions. Some authors seem to respond to this query in the affirmative, holding that such a conclusion applies to for example, CFC

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127 G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 644, no. 14.46; M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 173-174; J. Bundgaard, 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1' (2010) European Taxation, issue 10, 455; F. Vanistendael, 'Looking back: a decade of parent subsidiary directive – the case of Belgium' (2001) EC Tax Review, issue 3, 164.

128 F. Vanistendael, 'The implication of the Parent/Subsidiary Directive in the EC – Comments on some unresolved questions' (1992) Tax Notes International, 605. In the same vein: P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 273.

129 F. Vanistendael, 'The implication of the Parent/Subsidiary Directive in the EC – Comments on some unresolved questions' (1992) Tax Notes International, 605. In the same vein: P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 273.

130 With the nuance that the case law of the CJEU suggests that Article 5 PSD requires the existence of an actual payment and not a fictitious or notional payment (Case C-257/20 Viva Telecom Bulgaria [2022] ECLI:EU:C:2022:125, § 63). See further *infra* (section B.3.d.i)

131 P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 273.

rules,[132] transfer pricing rules[133] or provisions re-characterising certain forms of capital reductions/gains into dividend distributions.[134]

We can accept that the principle of "autolimitation" also applies, in principle, vis-à-vis the Member State of the parent company, but would limit its scope to deemed dividends (1) which actually meet the EU autonomous definition of a "profit distribution", which covers all transfers of assets or of any value to a parent company at the expense of the subsidiary (i.e. for no equivalent value or benefit in exchange) (see *supra*, section B.3.b.i), (2) which do not fall within the scope of the exclusion of liquidation gains[135] and (3) which are truly received by virtue of the parent company's association with its subsidiary.[136] **5.074**

On that basis, we contend that deemed dividends arising from domestic transfer pricing legislation and CFC rules do not require relief from economic double taxation under Article 4(1) PSD (as the deemed dividend is not, ordinarily, causally related to the shareholder relationship), and neither do deemed dividends resulting from rules re-characterising into dividend distributions certain liquidation gains (as they are excluded) or capital gains on shares (as they do not fall within the scope of the autonomous definition, failing a transfer at the expense of (the net assets of) the subsidiary).[137] Furthermore, as regards CFC rules, we believe that the CJEU will in any case be inclined to apply, *mutatis mutandis*, its case-law in *Viva Telecom Bulgaria*, in which the CJEU held that a profit distribution within the meaning of the PSD requires an actual payment or distribution, so that fictitious or notional payments are excluded.[138] Indeed, **5.075**

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132 G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 641, no. 14.42. In the same vein: M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 134-135. This argument applies in the context of CFC rules which use a 'deemed dividend' approach. The argument does not hold, on the other hand, in the case of CFC rules which are based on a 'transparency' approach (see also J. Kokott, *Das Steuerrecht der Europäischen Union* (Beck 2018), 295, no. 41).

133 M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 158.

134 In that sense P. Dibout, 'La directive communautaire du 23 juillet 1990 relative au régime fiscal commun applicable aux sociétés mères et filiales d'états membres différents' (1991) Droit Fiscal, étude 100007, no. 24.

135 For the latter conclusion, see also P. Dibout, 'La directive communautaire du 23 juillet 1990 relative au régime fiscal commun applicable aux sociétés mères et filiales d'états membres différents' (1991) Droit Fiscal, étude 100007, no. 24.

136 In a similar vein, see our view on the characterisation of share redemptions (see *supra*, section B.3.b.ii.).

137 That is not to say, however, that the Member States may not unilaterally provide such relief based on national policy objectives, as long as they respect primary EU law.

138 Case C-257/20 Viva Telecom Bulgaria [2022] ECLI:EU:C:2022:125, § 63. The case concerned an interest-free, 60-year, convertible loan granted by a Luxembourg parent company to a Bulgarian subsidiary, which gave rise to the Bulgarian tax authorities applying a transfer pricing correction by imputing a deemed (notional) interest, on which withholding tax was applied (a so-called "secondary adjustment"). Whist the case thus concerned Article 5 PSD, the CJEU's judgment is worded more broadly, in the sense

insofar as the deemed dividend under the laws of the Member State of the parent company is not accompanied by an actual payment received by the parent company, no recourse could be had to Article 4(1) PSD.[139] Finally, as regards transfer pricing rules, Member States may likely deny the benefits of the PSD by virtue of the anti-abuse clause under Article 1(4) PSD.[140] [Chapter 2]

5.076 We do see a scope for the application of a principle of autolimitation vis-à-vis the Member State of the parent company where a deemed dividend arises from a (full or partial) re-characterisation of a capital reduction into a dividend distribution under the latter's domestic tax rules.[141]

(ii) Hybrid financial instruments

5.077 The fact that the Member State of the parent company is not compelled to follow the (tax) characterisation made by the Member State of the subsidiary is also confirmed in the administrative practice of the EU Member States predating the introduction of the anti-hybrid rule in the PSD in order to address qualification conflicts with regard to hybrid financial instruments.[142] In the latter context, it had been defended that an obligation for the Member State of the parent company to accept the characterisation as profit distribution would only apply where the latter would have treated the instrument as equity as well on the basis of its domestic law or where it must accept the characterisation as equity for tax treaty purposes.[143]

5.078 A different question is to what extent payments received by virtue of hybrid financial instruments that are not formal equity (e.g. profit-sharing,

that (1) reference is made to the concept of "distributed profits" in general and (2) the CJEU holds that, in the case at hand, "Directive 2011/96 does not apply" within limiting this finding to Article 5 PSD. Note, however, that the CJEU's judgment has been subjected to criticism, see e.g. S. Kostikidis and F. Striefler, 'Fictitious Interest and Dividends Under Tax Treaties and the EU Directives' (2022) EC Tax Review, issue 5, 258 et seq. and G. Kofler, 'Fictitious Income and the EU Company Tax Directives', in O. Marres and D. Weber (eds.), *Rara avis. Liber Amicorum Peter J. Wattel* (Wolters Kluwer 2022), 134 et seq.

139 See in that sense also already F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 427 and G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 558.

140 C. Harris, 'The European Community's Parent-Subsidiary Directive' (1992) Florida Journal of International Law, 130 (at note 111). In that sense, the Belgian Supreme Court has upheld the denial of the Belgian participation exemption on taxable profits relating to a transfer pricing correction on the basis of (current) Article 1(4) PSD (Supreme Court 25 September 2020, F.19.0056.N, ECLI:BE:CASS:2020:ARR.20200925.1N.3).

141 Such rules apply, for instance in Belgium, where the distributing company has distributable profits.

142 See (ii) Anti-hybrid rule.

143 M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 174; E. Eberhartinger and M. Six, 'National Tax Policy, the Directives and Hybrid Finance' in K. Andersson, E. Eberhartinger and L. Oxelheim (eds.), *National Tax Policy in Europe* (Springer 2007), 227; M. Helminen, 'Classification of Cross-Border Payments on Hybrid Instruments' (2004) Bull. Int. Fisc. Doc., 61.

subordinated loans), in the sense of not creating a formal shareholder relationship, would be eligible for the benefits of Article 4(1) PSD. Certain doctrine has suggested that, as a principle, payments on these instruments could be in scope of Article 4(1) PSD, provided that, considering the ruling in *Les Vergers du Vieux Tauves*,[144] they are attributed to companies with a qualifying formal shareholding in the equity of the subsidiary.[145] Whilst this position, at first sight, seems to be confirmed by the introduction of the anti-hybrid rule to the PSD[146] (see section B.2.c.ii), it must be noted that the mere attribution of benefits to a formal shareholder does not, strictly speaking, entail that these benefits are also attributed *by virtue of* that formal shareholder relationship.[147]

(e) No other conditions

The exemption or tax credit required by Article 4(1) PSD may not be subjected to any other conditions than those discussed *supra*.[148] This excludes, for instance, a requirement that the parent company have taxable profits in order for the exemption method to apply.[149] Outside of the context of the prevention of abuse by virtue of Article 1(2) PSD, it is also not possible to impose a requirement for the subsidiary to carry on a qualifying level of activities to be able to benefit from relief of economic double taxation.[150] According to the CJEU, the requirement for taxpayers to introduce administrative or judicial appeals in order to benefit from relief of double taxation under Article 4(1) PSD might as well constitute such a prohibited additional condition.[151] **5.079**

144 Case C-48/07 Les Vergers du Vieux Tauves [2008] ECLI:EU:C:2008:758.

145 J. Bundgaard, 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1' (2010) European Taxation, issue 10, 451; J. Bundgaard, *Hybrid Financial Instruments in International Tax Law* (Wolters Kluwer 2017),195-168 and 206-211. Prior to *Les Vergers du Vieux Tauves*, several authors argued that the holding of a hybrid financial instrument could be considered as a holding in the capital of the company if the Member State concerned treated that financial instrument as equity (see M. Helminen, *The Dividend Concept in international Tax Law* (Kluwer 1999), 267; E. Eberhartinger and M. Six, 'National Tax Policy, the Directives and Hybrid Finance' in K. Andersson, E. Eberhartinger and L. Oxelheim (eds.), *National Tax Policy in Europe* (Springer 2007), 227).

146 In the same vein: G. Maisto, 'EU and OECD Convergence on International Tax Standards – Focus on Aggressive Tax Planning and Its Foreseeable Future Developments', in R. Danon (ed.), *Base Erosion and Profit Shifting (BEPS): Impact for European and international tax policy* (Schulthess 2016), 185-186.

147 See in that regard *e.g. supra* (section B.3.c.ii, *in fine*).

148 Case C-389/18 Brussels Securities SA [2019] ECLI:EU:C:2019:1132, § 34; Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2022:378, § 61. See also in legal doctrine, M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 270.

149 Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82, § 36.

150 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 270-271.

151 Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2022:378, § 60-61.

4. Unilateral deviations

5.080 The preceding sections have shown that, in general, Article 4(1) PSD compels the Member State of the parent company (or of its PE) to provide for relief of economic double taxation within its (personal, material and territorial) scope of application. Nothing precludes the Member States from implementing Article 4(1) PSD more broadly to situations falling outside its scope, such as (but not limited to):

- Dividend distributions between companies of the same Member State;
- Dividend distributions to companies not qualifying as a "company of a Member State" in the sense of Article 2 PSD or between companies which are not bound by a qualifying parent-subsidiary relationship within the meaning of Article 3 PSD;
- Liquidation distributions.

5.081 Such a unilateral extension of the scope of (Article 4(1) of) the PSD can be referred to as (horizontal) "gold-plating", and raises intricate queries in terms of that Member State's obligations in areas not technically covered by the scope of the PSD. A discussion of these queries, however, falls outside the scope of the present contribution.[152]

C. PARAGRAPH 2: HYBRID ENTITIES

1. Covered situations

5.082 One of the 2003 amendments to the PSD[153] concerned the introduction of a rule governing the so-called "outbound situation" in which a parent company (or its PE) holds a participation in and receives a profit distribution from a subsidiary company (which falls within the scope of the PSD[154]) qualifying (i) as opaque from the perspective of the Member State of the subsidiary but

152 For a more elaborate account of the issue of horizontal gold-plating, see e.g. J. Luts and W. Willems, 'The Legal Consequences of 'Horizontal Gold-Plating' of Direct Tax Directives for Belgian Taxpayers' in F. Debelva (ed.), *Liber Amicorum Luc De Broe. The Least Taxed Road. Essays at the occasion of Prof. Luc De Broe's emeritus ceremony* (Wolters Kluwer 2024), 349-414.

153 Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, *OJ* 13 January 2004, L 7, 41. This directive should have been implemented by the Member States by 1 January 2005 at the latest.

154 In this respect, it should be noted that some companies which are a corporate tax subject of a Member State and which take a company form listed in the Annex to the PSD may very well be treated as tax transparent by other Member States. See for a more detailed discussion M. Mayer and K. Spies, 'Hybride Gesellschaften in der Harmonisierung der direkten Steuern' (2017) StAW, 230-232.

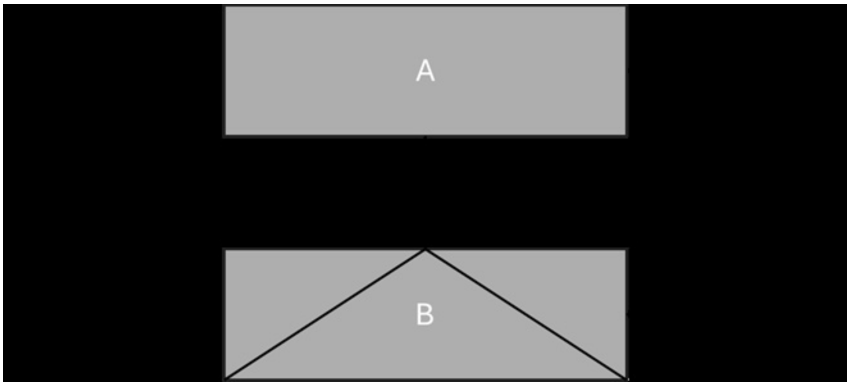

Figure 5.1 *xxx*

(ii) as tax transparent from the perspective of the Member State of the parent company (or its PE) (a "hybrid entity"), as illustrated below.

Article 4(2) PSD allows the Member State of the parent company (or its PE) **5.083**
to maintain its qualification, based on its domestic legislation, of the (foreign) subsidiary company as "tax transparent" and therefore to tax the income obtained by such a subsidiary company on a current basis in the hands of the parent company or its PE on a pro rata basis in function of the holding of the parent company or its PE. However, that Member State is under a two-fold obligation:

- to exempt the distributed profits of the subsidiary company (Article 4(1), first paragraph PSD[155]); and
- to either exempt the parent company's share of the profits of its subsidiary as they arise or give a tax credit for the taxes paid by the subsidiary (and any lower-tier subsidiary) up to the fraction of the corporation tax related to the parent company's share of the subsidiary's profits[156] (Article 4(1), second paragraph PSD).

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155 Which logically follows from the qualification of the subsidiary as a transparent entity from the perspective of the Member State of the parent company (or of its PE), see O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 128. See also R. Russo, 'Partnerships and Other Hybrid Entities and the EC Corporate Direct Tax Directives' (2006) European Taxation, 480, who notes that this obligation "appears to be meaningless".

156 Where the Member State of the parent company provides relief by virtue of the credit method, a tax credit should also be available for the sub-subsidiaries held by the hybrid subsidiary (e.g. R. Russo, 'Partnerships and Other Hybrid Entities and the EC Corporate Direct Tax Directives' (2006) European Taxation, 480; G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 34 and G. Fibbe and A. Stevens, 'The EU and OECD Approach to Hybrid Entities', in G. Fibbe and A. Stevens (eds.), *Hybrid Entities and the EU Direct Tax Directives* (Kluwer Law International 2015), 12).

5.084 That latter obligation is generally complied with where the Member State of the parent company has concluded a tax treaty with the Member State of the (tax transparent) subsidiary, if the Member State of the parent company considers that the subsidiary gives rise to a PE in the Member State of the subsidiary in the sense of tax treaty provisions modelled on Article 5 of the OECD Model Tax Convention, which means that it must provide relief from double taxation based on tax treaty provisions modelled on Article 7 and 23A or 23B of the OECD Model Tax Convention.[157]

5.085 In this respect, reference is also made in literature to (example 18 of) the OECD's "Partnership Report",[158] which makes clear that – under a tax treaty – the Member State of the parent company (irrespective of whether it provides an exemption or a tax credit in the sense of Article 23A resp. 23B of the OECD Model Tax Convention as regards income of the subsidiary on a current basis) is not expected to grant a tax credit for any withholding tax paid upon distribution by the subsidiary company; however, such an issue is not expected to arise under (Article 5 of) the PSD.[159]

5.086 The discussion in the OECD Partnership Report also makes clear that a tax treaty may not be sufficient to achieve the result required by Article 4(2) PSD. This is first and foremost the case where the subsidiary company does not constitute a PE, which is a condition for tax treaty relief, but not for the relief required by Article 4(2) PSD. Furthermore, granting tax treaty relief based on the credit method only seems to take into account taxes paid by the subsidiary company, and not the lower-tier subsidiaries.[160]

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157 G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 37. In the same vein (with respect to an exemption): J. Englisch & A. Schütze, 'The Implementation of the EC Parent-Subsidiary Directive in Germany Recent Developments and Unresolved Issues' (2004) European Taxation, 496 and R. Russo, 'Partnerships and Other Hybrid Entities and the EC Corporate Direct Tax Directives' (2006) European Taxation, 480.

158 OECD, *The Application of the OECD Model Tax Convention to Partnerships*, Paris, 1999, 48 *et seq.*

159 M. Tenore, 'Taxation of Dividends: A Comparison of Selected Issues under Article 10 OECD MC and the Parent-Subsidiary Directive' (2010) Intertax, issue 4, 225 and G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 36.

160 J. Englisch & A. Schütze, 'The Implementation of the EC Parent-Subsidiary Directive in Germany Recent Developments and Unresolved Issues' (2004) European Taxation, 496-497; G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 37 and G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 655, no. 14.69.

2. Situations not covered

(a) Reverse hybrids

Article 4(2) PSD does not provide for any rules on profit distributions made by "reverse hybrid companies", which qualify (i) as tax transparent from the perspective of the Member State of the subsidiary company but (ii) as opaque from the perspective of the Member State of the parent company (or of its PE). This is logical, as that subsidiary company would by assumption, not qualify as a "company of a Member State" within the meaning of Article 2(a) PSD.[161] **5.087**

(b) Allocation of income rules

In addition, Article 4(2) PSD only concerns cases where a subsidiary company (which is considered to be opaque by the Member State in which is established) is treated as tax transparent from the perspective of the Member State of the parent company on account of the latter Member State's assessment of "the legal characteristics of that subsidiary arising from the law under which it is constituted". **5.088**

The provision, therefore, does not apply where the subsidiary is treated as (quasi) tax transparent by the Member State of the parent company based on factors other than the legal characteristics of the subsidiary company, but on the basis of a tax regime (e.g. "rules of income attribution") which allocate(s) the income of the subsidiary to the parent company (e.g. CFC rules).[162] **5.089**

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161 See P. Arginelli, 'The Subject-to-Tax Requirement in the EU Parent-Subsidiary Directive (2011/96)' (2017) European Taxation 2017, 337-338 and S. Picariello, 'Hybrid entities and their treatment under the Parent-Subsidiary Directive and the Interest and Royalty Directive', in S. Govind & J.-P. Van West (eds.), *Hybrid Entities in Tax Treaty Law* (Linde 2020), 535-536. In the same vein: G. Fibbe and A. Stevens, 'The EU and OECD Approach to Hybrid Entities', in G. Fibbe and A. Stevens (eds.), *Hybrid Entities and the EU Direct Tax Directives* (Kluwer Law International 2015), 15.

162 G. Maisto, 'The 2003 amendments to the EC Parent-Subsidiary Directive: what's next?' (2004) EC Tax Review, issue 4, 175; R. Russo, 'Partnerships and Other Hybrid Entities and the EC Corporate Direct Tax Directives' (2006) European Taxation, 479; M. Tenore, 'Taxation of Dividends: A Comparison of Selected Issues under Article 10 OECD MC and the Parent-Subsidiary Directive' (2010) Intertax, issue 4, 225; G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 35; M. Helminen, *The International Tax Law Concept of Dividend* (Kluwer Law International 2017), 135; S. Picariello, 'Hybrid entities and their treatment under the Parent-Subsidiary Directive and the Interest and Royalty Directive', in S. Govind & J.-P. Van West (eds.), *Hybrid Entities in Tax Treaty Law* (Linde 2020), 536; G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 655, no. 14.68 and O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 553.

D. PARAGRAPH 3: LOSSES AND CHARGES

1. Introduction

5.090 Article 4(3) PSD contains two distinct options (not obligations[163]) for the Member States which, in essence, allow Member States to prevent that so-called "double dip" situations would arise, whereby charges or losses can be deducted whilst the corresponding profits (profit distributions received) are exempt.[164]

2. Losses related to profit distribution

5.091 As per a first optional provision, which is embedded in the first paragraph of Article 4(3) PSD, the Member States are allowed to deny the deduction of any losses connected to the distribution of profits from the taxable profits of the parent company.

5.092 This provision is aimed at situations in which, following a profit distribution out of retained earnings by the subsidiary company, the value of the shares in the subsidiary held by the parent company falls (which would then give rise to a tax deduction).[165] The PSD does not require the Member State of the parent company to allow for the tax deductibility of such "book losses".[166] Two observations must be made in this respect:

163 See already G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 565.

164 Case C-48/07 Les Vergers du Vieux Tauves [2008] ECLI:EU:C:2008:758, § 42 ; Case C-39/16 Argenta Spaarbank [2017] ECLI:EU:C:2017:813, § 54. See also J. Kokott, *EU Tax Law* (Beck, 2022), 380, no. 52. In early literature, some scholars had argued that such options only applied in the case of use of the credit method (G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 565. Implicitly (possibly only partially), see also e.g. F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 432; P. Dibout, 'La directive communautaire du 23 juillet 1990 relative au régime fiscal commun applicable aux sociétés mères et filiales d'états membres différents' (1991) Droit Fiscal, étude 100007, no. 32 and M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 272-273). However, this contention is not supported by the text of Article 4(3) PSD and is contradicted by more recent legal doctrine, see e.g. G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 655-656, no. 14.70.

165 E.g. F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 432 and O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 133, both with reference to the Minutes of the Council meeting.

166 O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 548.

- Technically, this is not so much a "loss" but rather an "impairment" (reduction of the book value).[167]
- This issue only seems to arise in Member States (of parent companies) in which there is an inextricable link between accounting law and tax law and where there are no tax-specific rules for determining the value of a shareholding in a subsidiary company.[168]

The date on which the underlying profits (which have generated those retained earnings) were earned seems to be irrelevant. Consequently, capital losses recorded on account of distributions of retained earnings which were accumulated before the parent company acquired the relevant shareholding in the subsidiary are equally caught by the provision.[169] **5.093**

In view of the *ratio legis* of such rule, it has been argued that capital losses arising on account of a profit distribution which is not eligible for the benefits of the PSD (for example, due to not meeting the holding period condition) and which is therefore taxed by the Member State of the parent company, should remain tax deductible.[170] **5.094**

3. Charges related to the holding

A second optional provision for the Member States is to provide that any charges relating to the respective holding in the capital of the subsidiary are not tax deductible.[171] The extent to which the relevant charges (see *infra*) may be disallowed for tax purposes is not spelled out in Article 4(3) PSD.[172] Consequently, Member States are free to disallow either part of or the entire amount of the relevant charges. **5.095**

167 F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 432; C. Harris, 'The European Community's Parent-Subsidiary Directive' (1992) Florida Journal of International Law, 137.

168 O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 133.

169 G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 568.

170 G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 567.

171 When a Member State has implemented the credit method in Article 4(1) PSD, this can be done through the attribution to and deduction of these expenses from the respective dividend income, lowering the domestic tax on these dividends and, in turn, lowering the maximum amount of the tax credit, see O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 548.

172 Contrary to the initial proposal for a directive, see M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 273.

5.096 The question arises which types of charges are actually envisaged by that rule. Certain authors have initially argued that the option in Article 4(3) PSD also includes the discretion for Member States to determine *which types* of charges are considered.[173] However, the majority in legal doctrine seems to be of the view that the nature of these charges is determined by the PSD. In that respect, early legal doctrine referred to the concept of "shareholder costs" within the meaning of transfer pricing rules,[174] which includes costs related to the management and protection of the participation in the subsidiary, but also costs in connection with the acquisition of such participations, including financing costs.[175] Other legal scholars have also accept(ed) that the concept of "charges related to the holding" is sufficiently broad to also cover these financing costs.[176]

5.097 The latter interpretation seems to be confirmed in the case-law of the CJEU. Although Article 4(3) PSD contains an exception to the general rule of exemption or tax credit, and must therefore be interpreted strictly,[177] it follows from *Argenta Spaarbank* that Article 4(3) PSD allows Member States to consider as non-deductible the interest charges that are linked to the acquisition of holdings of which the dividends may benefit from double taxation relief based on Article 4 PSD.[178] To be sure, a clear link between the charges and the respective holding must be established.[179] As such, Article 4(3) PSD precludes a blanket exclusion (non-deductibility) of all costs of a parent company up to the

173 P. Dibout, 'La directive communautaire du 23 juillet 1990 relative au régime fiscal commun applicable aux sociétés mères et filiales d'états membres différents' (1991) Droit Fiscal, étude 100007, no. 33.

174 G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 566 (footnote 108). In the same vein, F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 432.

175 See current § 7.10 of the OECD 2022 TP Guidelines.

176 E.g. P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 269; M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 273 and O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 130. For more recent legal doctrine, see also G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 656, no. 14.70 ; J. Kokott, *EU Tax Law* (Beck, 2022), 380, no. 52 and O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 547.

177 See Case C-39/16 Argenta Spaarbank [2017] ECLI:EU:C:2017:813, § 50-51.

178 See Case C-39/16 Argenta Spaarbank [2017] ECLI:EU:C:2017:813, § 55-56 (*a contrario*).

179 See in that sense also M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 273 and O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 547-548.

amount of the exempt profit distributions received from qualifying participations in subsidiaries, regardless of any link with a qualifying holding.[180]

The text of Article 4(3) PSD does not make a link between the "charges related to the holding" and any profit distribution made by the relevant subsidiary. Consequently, the relevant charges may be disallowed even if the subsidiary company does not (yet) distribute any profits to the parent company.[181] Against that backdrop, some have argued that it would be more in line with the objective of the PSD to only disallow costs to the extent of any profit distributions received.[182] However, such a proportionate rule would be difficult to administer.[183] **5.098**

Finally, according to the CJEU, the EU fundamental freedoms require to implement the option in Article 4(3) PSD in a symmetrical manner.[184] It is therefore not possible for a Member State to deny deductibility only with regard to foreign holdings (the distributed profits of which are exempt under the PSD), whist allowing deductibility for domestic holdings.[185] Remarkably, according to the CJEU, this is true even if the profits relating to domestic holding are taxable in that Member State.[186] **5.099**

4. Lump sum determination

The second paragraph of Article 4(3) PSD allows Member States to fix the management costs related to the holding on a lump sum basis, but subject to a maximum ("cap") of 5 % of the distributed profits from the subsidiary. **5.100**

Whist the notion of "charges" in the first paragraph of Article 4(3) PSD encompasses not only management costs but also other "shareholder costs", **5.101**

180 Case C-39/16 Argenta Spaarbank [2017] ECLI:EU:C:2017:813, § 50-51.

181 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 273 and G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 656, no. 14.70.

182 M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 273-274.

183 When a company first incurs important financing costs to acquire a shareholding which will only yield distributed profits in future years, states of limitations would generally not allow to disallow these earlier financing costs.

184 Case C-386/14 Groupe Steria [2015] ECLI:EU:C:2015:524, § 39; Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774, § 46; Case C-471/04 Keller Holding [2006] ECLI:EU:C:2006:143, § 45; Case C-168/01 Bosal [2003] ECLI:EU:C:2003:479, § 26.

185 Case C-471/04 Keller Holding [2006] ECLI:EU:C:2006:143; Case C-168/01 Bosal [2003] ECLI:EU:C:2003:479.

186 Case C-168/01 Bosal [2003] ECLI:EU:C:2003:479. For a criticism, see O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 548-549.

such as financing costs (see section D.3), the second paragraph of that provision only refers to "management costs". The question therefore, arises whether the second paragraph of Article 4(3) PSD has a more limited scope than that of the first paragraph. Whilst some scholars seem to respond to this question in the affirmative,[187] others have argued that the lump sum determination should equally apply to all other charges relating to the holding. After all, that provision was introduced as a reaction to existing practices in certain Member States, which provided for an exemption minus a lump sum percentage deemed to represent management and financial costs.[188] Article 4(3) PSD codified that practice, but subject to a cap of 5%. Consequently, the notion of "management costs" should be considered as synonymous to the notion of "charges relating to the holding".[189] Implicitly, the CJEU seems to be of the same position.[190]

5.102 The application of the lump sum regime means (i) that only 95% of the profit distribution is eligible for double taxation relief under Article 4(1) PSD[191] and (ii) that if the actual charges related to the holding (which are fully deductible in such a scenario[192]) exceed 5% of the profit distribution received, the application of the lump sum regime by a Member State may be tax-beneficial for the parent companies involved.[193]

5.103 Like the (non-)deductibility of charges (see section D.3.), such a lump sum regime should be implemented in a symmetrical manner, in line with the fundamental freedoms.[194]

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187 In that sense, F. Vanistendael, 'The implication of the Parent/Subsidiary Directive in the EC – Comments on some unresolved questions' (1992) Tax Notes International, 609-610.

188 F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 432 and P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 270.

189 In that direction, G. Maisto, 'La direttiva Cee relativa al regime tributario dei dividendi nei rapporti tra "società figlie" e "società-madri' (1992) Rivista di diritto tributario, 567.

190 See e.g. Case C-68/15 X [2017] ECLI:EU:C:2017:379, § 72, 74-75 and 80; Case C-365/16 AFEP and Others [2017] ECLI:EU:C:2017:378, § 25-26 and 32 (where reference is made to the "ceiling of 5%").

191 G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 657, no. 14.71.

192 The option to determine the non-deductible charges on a lump sum basis is an alternative to considering the actual charges as non-deductible – see G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 657, no. 14.71, with reference to M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Verlag Österreich 1994), 274.

193 O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 131. Conversely, where these actual charges are only minimal and hence less than 5% of the profit distribution received, negative tax consequences ensue for the parent company (G. Kofler, 'Mutter-Tochter-Richtlinie', in H. Schaumburg, J. Englisch and L. Dobratz (eds.), *Europäisches Steuerrecht* (Otto Schmidt 2025), 657, no. 14.71).

194 Case C-386/14 Groupe Steria [2015] ECLI:EU:C:2015:524.

E. PARAGRAPHS 4 AND 5: EU COMPANY TAX REGIME

1. Sunset clause

It is provided in Article 4(4) PSD that the main rule on the relief of economic double taxation (see section B) and the complementary rule on hybrid entities (see section C) are retired when "a common system of company taxation" enters into force.[195] **5.104**

It is noted in legal doctrine that this provision, which was already present in the original version of the PSD (Directive 90/435/EEC), may have been introduced as a "successor" to Article 7 of the original proposal for directive, which provided for the establishment of a system of tax consolidation at Community level, but which was cancelled in the course of the discussions in the Council.[196] Reference is also made to a Commission proposal of 23 July 1975 for a directive on a common system of corporation tax and withholding tax on dividends,[197] which was nevertheless withdrawn on 18 April 1990 (shortly before the adoption of the original version of the PSD).[198] As from 2004, this rule could be thought of as referring to the adoption of the CCCTB.[199] As per today, with the withdrawal of the (C)CCTB proposal, the common EU company tax regime in the sense of Article 4(4) (and 4(5)) PSD would be the BEFIT.[200] **5.105**

In the absence of any binding effect to achieve an agreement on a common company tax regime within the EU within a specific deadline, this provision is of little practical relevance.[201] **5.106**

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195 That sunset clause does not extend, however, to the rule on losses and charges in Article 4(3) PSD (see section D) (Case C-168/01 Bosal [2003] ECLI:EU:C:2003:479, § 24).

196 O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 138.

197 COM(75) 392 final.

198 O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 139. Reference to that proposal is also made by P. Dibout, 'La directive communautaire du 23 juillet 1990 relative au régime fiscal commun applicable aux sociétés mères et filiales d'états membres différents' (1991) Droit Fiscal, étude 100007, no. 36.

199 Indeed, around the same time of the adoption of Directive 90/435/EEC, the so-called 'Ruding Committee' was tasked with, *inter alia*, analysing the feasibility of a consolidated corporate income tax basis on a Community basis.

200 O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 525.

201 E.g. O. Thömmes and K. Nakhai, 'Commentary on the Parent-Subsidiary Directive', in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2007), no. 138; G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen

2. Mandatory revision

5.107 Article 4(5) PSD specifies that, once the sunset clause (see section E.1) would enter into effect, the Council shall adopt the revised rules which should apply as from that date, subject to the procedure of Article 192(2) TFEU.[202] However, this provision does not constitute a legal basis provision allowing the Council to harmonise corporate tax legislation beyond Article 115 TFEU.[203]

Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 44 and H. Weber-Grellet, 'Mutter-Tochter-RL', in A. Musil & H. Weber-Grellet (eds.), *Europäisches Steuerrecht* (Beck 2022), 354, no. 28.

202 Under the initial version of the PSD (Directive 90/435/EEC), it was merely provided that the Council would adopt these rules. This wording was revised under the influence of the CJEU's judgment in *Parliament v. Council* (Case C-133/06 Parliament v. Council [2008] ECLI:EU:C:2008:257), since such a provision did not correspond to the designated decision procedures laid down in the EC Treaty (*in casu* Article 175(2) EC; now Article 192(2) TFEU). See also the Explanatory Memorandum of the EU Commission's proposal (COM(2010) 784 final, § 3-4 and O. Marres, 'The Parent-Subsidiary Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 525).

203 G. Kofler, 'Artikel 4. Entlastung von der wirtschaftlichen Doppelbesteuerung', in *Mutter-Tochter-Richtlinie: Kommentar* (LexisNexis 2011), no. 44.

6

ARTICLE 4(2): HYBRID ENTITIES AND THE AVOIDANCE OF DOUBLE TAXATION

Félix Daniel Martínez Laguna

Nothing in this Directive shall prevent the Member State of the parent company from considering a subsidiary to be fiscally transparent on the basis of that Member State's assessment of the legal characteristics of that subsidiary arising from the law under which it is constituted and therefore from taxing the parent company on its share of the profits of its subsidiary as and when those profits arise. In this case the Member State of the parent company shall refrain from taxing the distributed profits of the subsidiary.

When assessing the parent company's share of the profits of its subsidiary as they arise the Member State of the parent company shall either exempt those profits or authorise the parent company to deduct from the amount of tax due that fraction of the corporation tax related to the parent company's share of profits and paid by its subsidiary and any lower-tier subsidiary, subject to the condition that at each tier a company and its lower-tier subsidiary fall within the definitions laid down in Article 2 and meet the requirements provided for in Article 3, up to the limit of the amount of the corresponding tax due.

COMMENTARY

A. INTRODUCTION

6.001 Hybrid entities pose numerous challenges due to the conflict of qualification they are built upon across borders. The hybrid feature of these entities relates to the qualification as taxpayer and non-taxpayer for corporate income tax purposes in different jurisdictions – i.e. transparent and non-transparent (or opaque) – potentially leading to cross-border outcomes of double taxation and double non-taxation. These hybrid entities, as well as hybrid financial instruments, have been in the spotlight over the last decade as they may lead to double non-taxation, and also because of the significant attention they have received within the OECD BEPS Project and the so-called EU Anti-tax avoidance directive.[1] Nevertheless, and notwithstanding the relevance of the 1999 OECD Partnership Report,[2] hybrid entities gained prominence in the 2003 Parent-Subsidiary Directive amendment to prevent double taxation outcomes related to situations in which subsidiaries of a Member State are considered fiscally transparent from the perspective of the Member State of the parent.[3]

6.002 This chapter is devoted to the analysis of the very specific measure related to hybrid entities laid down in Article 4(2) PSD.[4] In doing so, section B provides a general overview of the concepts of hybrid and reverse hybrid entities and the outcomes of double taxation and double non-taxation they may lead to within

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1 See OECD, *Hybrid Mismatch Arrangements. Tax Policy and Compliance Issues* (OECD Publishing 2012), para. 10 [hereinafter, Hybrid Mismatch Report]; and, particularly, OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report* (OECD Publishing 2015). *See also,* in the EU context, TAXUD, *Staff Working Paper – The internal market: factual examples of double non-taxation cases, Consultation Document* 2012) and particularly, Council Directive 2014/86/EU of 8 July 2014 Amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States [hereinafter Parent-Subsidiary Amending Directive (2014/86) or PSAD (2014/86)]; Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market*;* and Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

2 OECD, *The application of the OECD Model Tax Convention to Partnerships. Issues in international Taxation 6* (OECD Publishing 1999).

3 Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of Parent companies and subsidiaries of different Member States, Annex I, Part A [hereinafter, Parent-Subsidiary Amending Directive (2003/123) or PSAD (2003/123)].

4 This Art. 4(2) PSD was first introduced in the Parent-Subsidiary Directive as Art. 4(1a) by Parent-Subsidiary Amending Directive (2003/123).

and without the European Union. Notwithstanding that the concept of company and related issues within the Directive are already addressed in another chapter of this book (Chapter 4), section C digs briefly into the absence of recognition of entities – "companies" – and, particularly, of their corporate income tax status in other Member States for the purposes of the Directive (Article 2), extrapolating to it the consequences of the domestic conflict of qualification that may lead to double taxation. After such analysis, this section deals with Article 4(2) PSD and the tax treatment provided to profits in outbound situations whenever a hybrid entity is at stake. It is divided into two parts dealing with (i) the possibility for parent jurisdictions to qualify and treat entities ("subsidiaries") located in a different Member State as fiscally transparent according to its own law, as well as taxing the profits accordingly, and (ii) the method(s) and requisites for the avoidance of double taxation at the level of the parent company, if that is the case. Lastly, this section provides an analysis on specific issues related to *reverse hybrid entities* in inbound situations in relation to Article 5, which complements the analysis of the previous issue.

B. HYBRID ENTITIES: A CAUSE OF CONCERN WITHIN AND WITHOUT THE EU

1. Hybrid and reverse hybrid entities in brief

Article 4(2) PSD does not contain any reference to the term "hybrid", nor does the PSD itself.[5] However it deals with the *tax transparency* of subsidiaries and the qualification – and tax treatment – that the Member State where a parent entity is located applies to the subsidiaries of those entities according to its own law within the boundaries of the Directive. **6.003**

In general terms, the *hybrid character* of entities relates to their different qualification as taxpayers and non-taxpayers, i.e., as transparent or non-transparent (opaque) entities for tax purposes, by the jurisdictions where the entities **6.004**

5 The term hybrid was however considered in the preparatory documents of the Parent-Subsidiary Amending Directive (2014/86) with respect to the amendment of the exemption method laid down in Article 4(1)(a) PSD. In short, this amendment dealt with particular hybrid financial instruments leading to outcomes of double non-taxation (so called hybrid loans). *See* Proposal for a Council Directive, of 25 November 2013, amending Directive 2011/96/EU on the common system of taxation applicable in the case of Parent companies and subsidiaries of different Member States COM(2013) 814. *See,* for a comprehensive analysis of Article 4(1)(a) PSD¸ (Chapter 5). *See also,* for the analysis of the Parent-Subsidiary Amending Directive (2014/86) and the twist it represented in terms direct taxation within the EU, F. Martínez Laguna, *Hybrid Financial Instruments, Double Non-taxation and Linking Rules* (Kluwer Law International 2019), 224-232.

and the shareholders/partners/participants are located.[6] The concept of *hybrid entity* is inherently attached to (and defined by) a conflict of qualification across borders that may lead to a disparity in the allocation of *e.g.* the same income and expenses to different taxable persons located in different jurisdictions.[7] Hybrid entities are the genus that includes two different species: *direct hybrid entities* and *reverse hybrid entities.* On the one hand, a *direct hybrid entity* is the entity that qualifies as a taxpayer (non-transparent, opaque) according to the legislation of the jurisdiction where it is incorporated, but it nevertheless qualifies as non-taxpayer (*transparent*) in other jurisdictions according to their own legislation, *e.g.* in those jurisdictions where shareholders/partners/participants are located. On the other hand, a *reverse hybrid entity* is transparent for tax purposes (non-taxpayer) in the jurisdiction where it is incorporated, but it is qualified for tax purposes as non-transparent (taxpayer) by other jurisdictions according to their own legislation.[8] Figure 6.1 shows both realities for entity B, jurisdiction B being its jurisdiction of incorporation.

6.005 A diagram showing a company established in jurisdiction A that holds a participation in a hybrid entity established in jurisdiction B. The left-hand side of the diagram concerns a direct hybrid entity, meaning that jurisdiction A considers the entity established in jurisdiction B to be transparant while jurisdiction B considers that entity to be non-transparent. The right-hand side concerns a reverse hybrid entity, meaning that jurisdiction A considers the entity established in jurisdiction B to be non-transparant while jurisdiction B considers that entity to be transparent.

6.006 In a nutshell, the existence of a hybrid entity demands its different tax qualification as a taxpayer (non-transparent) and as a non-taxpayer (transparent) according to the (tax) law of different jurisdictions, *e.g.* the jurisdiction of a parent entity and the jurisdiction of its subsidiary.[9] This conflict of qualification, which hybrid entities are built upon, may definitely lead to the allocation

6 *See* OECD (2012), Hybrid Mismatch Report, 7, para. 10, where hybrid entities are defined as those "[e]ntities that are treated as transparent for tax purposes in one country as non-transparent in another country".

7 "After all, hybrids and reverse hybrid entities exist exclusively because of the different characterization of the same entity by two jurisdictions". *See* L. Parada, *Double non-taxation and the use of hybrid entities* (2nd ed., Kluwer Law International 2023), 189.

8 *See* L. Parada, *Double non-taxation and the use of hybrid entities* (2nd ed., Kluwer Law International 2023), 118.

9 *See,* for an analysis on the different methods for the characterization of entities, L. Parada, *Double non-taxation and the use of hybrid entities* (2nd ed., Kluwer Law International 2023), 109-188. *See also* D.J. Jiménez-Valladolid de L'Hotellerie-Fallois and F.A. Vega Borrego, 'Legal Personality, Limited Liability and CIT Liability', in D. Gutman (ed), *Corporate Income Tax Subjects* (EATLP 2015), 21-29.

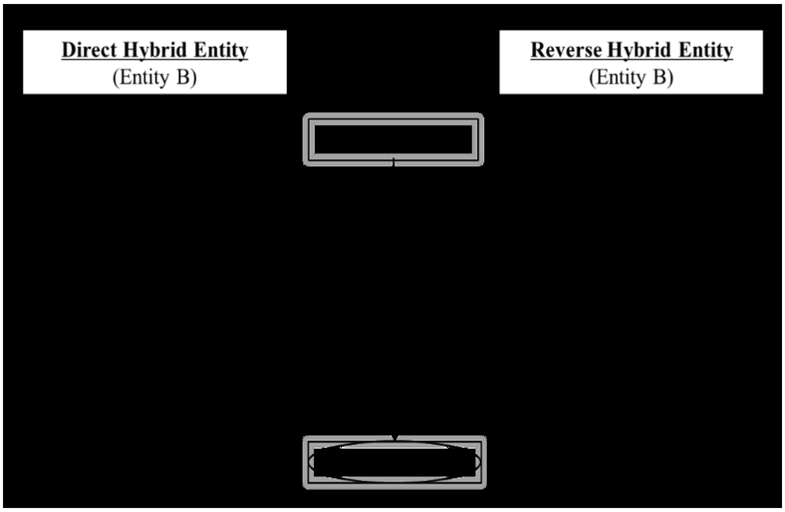

Figure 6.1 Direct hybrid entity and reverse hybrid entity

of the same "income, gains, and assets and liabilities to different persons",[10] and, consequently, to cross-border outcomes of double taxation and double non-taxation.[11]

2. Conflicts of qualification and the (potential) outcome of double taxation and double non-taxation

Although the conflict of qualification and the hybrid character of an entity is **6.007**
a mere consequence of two jurisdictions duly applying their own domestic law as parallel exercises of sovereignty, it may result in double taxation and double non-taxation across borders. Double taxation may arise in situations where a parent entity (entity P), located in a particular jurisdiction (jurisdiction P), qualifies one of its subsidiaries (entity S), located in a different jurisdiction (jurisdiction S), as fiscally transparent according to its own domestic law (P legislation). At the same time, and according to the corporate income tax law of the jurisdiction where the subsidiary is located, the same entity S is considered as non-transparent and, consequently, liable to taxation there. Now, in broad terms, one of the consequences may be that profits of the subsidiary are allocated to both the parent and the subsidiary at the same time for corporate

10 *See* T. Stevens and G. Fibbe, 'Taxation of hybrid entities under the Parent-Subsidiary Directive: The example of the Netherlands' (2011) EC Tax Review, issue 5, 242.

11 *See* R. Russo, 'Partnerships and other hybrid entities and the EC corporate direct tax Directives' (2006) European Taxation, issue 10, 478.

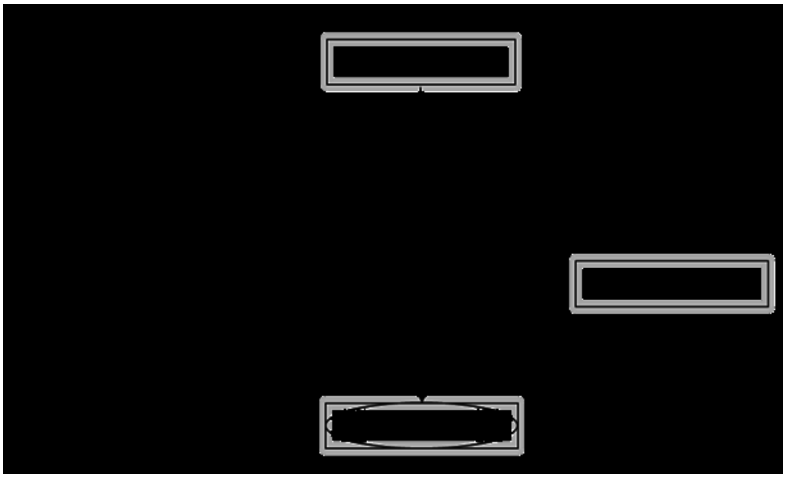

Figure 6.2 Example of double taxation – Direct hybrid entity

income tax purposes, leading to double taxation, notwithstanding the potential withholding tax that may apply in State S whenever the profits are distributed to the parent entity at a later point in time, if that is the case.[12]

6.008 Figure 6.2 shows a situation in which entity S (direct hybrid entity) lends money to a non-related firm C and makes income out of such a transaction in the form of interest. Given that entity S is non-transparent and liable for corporate income tax in jurisdiction S, as well as transparent (non-taxpayer) for corporate income tax purposes in jurisdiction S from the perspective of jurisdiction P, the income will be allocated to both entity S (subsidiary) and entity P (parent entity) and included in the taxable bases of both entities, potentially leading to double taxation.

6.009 A diagram showing parent entity P, established in jurisdiction P, and subsidiary entity S, established in jurisdiction S. Entity S receives interest from a third party, entity C. Jurisdiction P considers entity S to be transparent while jurisdiction S considers that entity S is non-transparent. As a result, jurisdiction P allocates the interest as taxable income to entity P while jurisdiction S allocates the interest to entity S.

6.010 If the facts of the previous example are slightly altered by entity S borrowing money from entity C instead of lending it, interest from entity S to entity C

12 *See* G. Fibbe and T. Stevens, 'Comparative Analysis, Conclusions and Recommendations', in G. Fibbe and T. Stevens (eds), *Hybrid Entities and the EU Direct Tax Directives* (Wolters Kluwer 2014), 250.

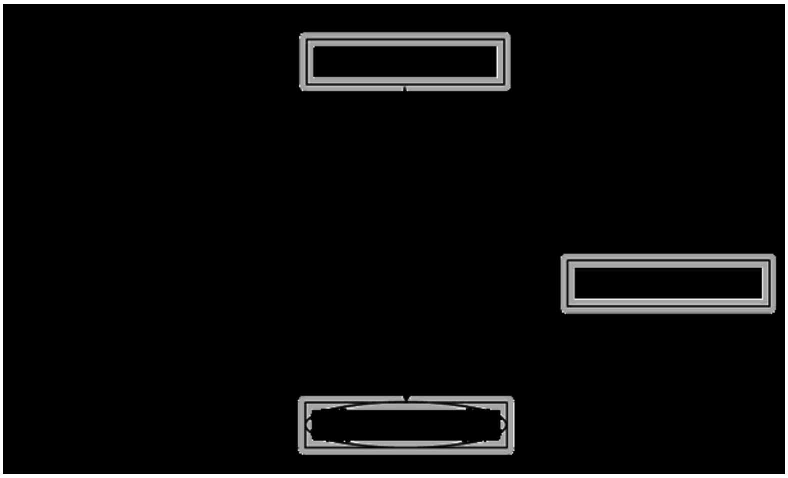

Figure 6.3 Example of double non-taxation – Direct hybrid entity

would be deductible in the hands of both entity S and entity P, potentially leading to double non-taxation in turn. This is because entity S is qualified as non-transparent and transparent by jurisdiction S and jurisdiction P, respectively, and the deductibility of interest payments is allocated to both entities (entity P and entity S). Notwithstanding the need for additional features to fully ascertain such an outcome of double non-taxation (e.g. consolidation with other entities in jurisdiction S), Figure 6.3 shows graphically the abovementioned example.

A diagram showing parent entity P, established in jurisdiction P, and sub- **6.011**
sidiary entity S, established in jurisdiction S. Entity S pays interest to a third party, entity C. Jurisdiction P considers entity S to be transparent while jurisdiction S considers that entity S is non-transparent. As a result, jurisdiction P allows for entity P to deduct the interest payment while jurisdiction S allows for entity S to deduct that payment.

In addition to the specific measure included in Article 4(2) PSD,[13] hybrid **6.012**
entities (as well as hybrid financial instruments) have been in the limelight in recent years solely due to the potential outcome of double non-taxation that

13 *See*, for further detail *infra* section C.2.

may stem out of them,[14] without double taxation even being in the picture.[15] Indeed, both the OECD and the EU proposed and implemented measures (i.e. *linking rules*) to avoid specific outcomes of double non-taxation stemming from the *hybrid mismatches* within their initiatives to tackle abuse and base erosion and profit shifting.[16] Nevertheless, and just as a brief note here, double non-taxation stemming from cross-border conflicts of qualification related to hybrid entities and hybrid financial instruments does not necessarily relate to abuse or the so-called base erosion and profit shifting, but to a mere consequence of two jurisdictions exercising their tax sovereignty.

C. HYBRID ENTITIES IN THE PARENT-SUBSIDIARY DIRECTIVE

1. The (conflict of) qualification: "company" v. hybrid entity

6.013 The term *company* is undoubtedly one of the key concepts within the PSD as the gateway to apply its benefits. Although this concept has been extensively analysed earlier in this book,[17] it is worth recalling here the three requisites that an entity must fulfil to gain access to this piece of EU Secondary Law.[18] The *company* (in the words of the Directive) must (i) *take one of the forms listed in Annex I, Part A* of the very PSD, (ii) be considered to be resident in a Member State for tax purposes,[19] and be subject to one of the taxes listed in Annex I, Part B, *without the possibility of an option* or of being exempt, or to any tax which may be substituted for any of those taxes".

6.014 There is one particular aspect of this definition of company that must be briefly assessed at this point.[20] The Parent-Subsidiary Amending Directive (2003/123) expanded the list of entities that may be entitled to the benefits

14 *See,* as an example of the vast array of initiatives tackling outcomes of double non-taxation related to hybrid financial instruments, hybrid entities and other hybrid mismatches, *supra* footnote 1.

15 Although in terms of hybrid financial instruments, De Broe rightly considers that "the fact that such structures [hybrid financial instruments] can also give rise to double taxation is largely ignored in these initiatives". *See* L. De Broe, 'At last, Some Output on the Fight against Double Non-Taxation' (2014) EC Tax Review, issue 6, 110.

16 *See,* again, *supra* footnote 1. *See,* for an analysis of the OECD and EU linking rules related to hybrid financial instruments, F. Martínez Laguna, *Hybrid Financial Instruments, Double Non-taxation and Linking Rules* (Kluwer Law International 2019). *See,* in terms of linking rules and hybrid entities, L. Parada, *Double non-taxation and the use of hybrid entities* (2nd ed., Kluwer Law International 2023),.

17 *See,* in this regard, Chapter 4.

18 *See* Article 2 PSD.

19 The requisite is complemented by the company not being resident for tax purposes outside the EU under the terms of a double taxation agreement concluded with a third State. *See* Article 2(a)(ii) *in fine*.

20 *See,* with respect to the relevance of the subject to tax clause in reverse hybrid situations, *infra* section C.

of the Directive.[21] That expansion consisted not only of some Member States introducing *catch-all entity clauses* in the Annex[22] (with entities potentially qualifying as hybrid entities might be included), but also of the introduction of specific entities of Member States that are likely to qualify as hybrid entities across borders.[23] The proposal of the 2003 amending PSD explicitly considered that "[s]ome of the new entities proposed for inclusion in the list [i.e. Annex I, Part A] raise a particular *technical* problem" (emphasis added).[24] This basically relates to the qualification of *listed* subsidiaries located in a Member State as transparent entities by the Member State where the parent entity is located. The Explanatory Memorandum of the Proposal read as follows with respect to this *technical* problem:

> [i]t could be the case that the Member State where an entity is established treats it for its own tax purposes as a corporate taxpayer whereas another Member State whose resident has an interest in that same entity treats it for its own tax purposes as transparent (i.e. it looks through the "corporate" structure). The latter State attributes the income of the entity to its resident having an interest in the entity and taxes it accordingly. This Member State should be obliged to extend the benefits of the Directive to that resident with an interest in the entity.[25]

This *technical* problem, *i.e.* a conflict of qualification that may lead to double taxation, relates to the mere parallel exercise of sovereignty by two Member States and the autonomy of Member States to qualify non-resident 'companies' for the purposes of their domestic corporate income taxes according to their **6.015**

21 *See* G. Fibbe, 'The different translations of the term 'company' in the Merger Directive and the Parent-Subsidiary Directive: a Babylonian confusion of tongues?' (2006) EC Tax Review, issue 2, 95. *See* PSAD (2003/123), Annex I, Part A.

22 *See* G. Maisto, 'The 2003 amendments to the EC Parent-Subsidiary Directive: What's next?' (2004) EC Tax Review, issue 4, 171 ["The new legal forms are mentioned either expressly or (indirectly) through a broad reference to other 'companies' – or 'entities' – constituted under the laws of the Member State and subject to corporate tax therein (so called 'residual entities clause')]. *See also* F. Boulogne and W. Geursen, 'Gaz de France: Dividends to Companies Not Listed in the Parent-Subsidiary Directive Are Not Exempt' (2010) European Taxation, issue 4, 138-140.

23 *See* F. Boulogne and W. Geursen, 'Gaz de France: Dividends to Companies Not Listed in the Parent-Subsidiary Directive Are Not Exempt' (2010) European Taxation, issue 4, 139. *See also* G. Fibbe, 'The different translations of the term 'company' in the Merger Directive and the Parent-Subsidiary Directive: a Babylonian confusion of tongues?' (2006) EC Tax Review, issue 2, 100: "also a hybrid company remains a 'company' for the purposes of the Directive [. . .]".

24 *See* Proposal for a Council Directive, of 29 July 2003, amending Directive 90/435/EEC on the common system of taxation applicable in the case of Parent companies and subsidiaries of different Member States, COM(2003) 462, Explanatory Memorandum, recital 15 *in fine* [hereinafter, Proposal for PSAD (2003/123)]. *See also* G. Maisto, 'The 2003 amendments to the EC Parent-Subsidiary Directive: What's next?' (2004) EC Tax Review, issue 4, 175.

25 *Ibid*, recital 15 *in fine*. *See*, with respect to such obligation, *infra* section C.2.b.

own law,[26] provided that this is not done in a discriminatory fashion.[27] It also relates to the lack of recognition of every *company* subject to tax in a Member State for the purposes of the Directive.[28] The Parent-Subsidiary Amending Directive 2003/123 introduced a measure – i.e., the current Art. 4(2) PSD – in order to partially solve this problem by avoiding specific outcomes of double taxation that may stem from the conflict of qualification of hybrid entities (exclusively) in outbound situations.[29] Indeed, the Parent-Subsidiary

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26 *See* Art. 4(2) PSD. Stevens and Fibbe rightly state that "[f]or outbound situations, Article 4, paragraph 1a, of the Directive [current Art. 4(2)] explicitly recognizes the autonomy of Member States in respect of an entity's tax classification". *See* T. Stevens and G. Fibbe, 'Taxation of hybrid entities under the Parent-Subsidiary Directive: The example of the Netherlands' (2011) EC Tax Review, issue 5, 243. *See also,* in this regard, PSAD 2003/123, Preamble, recital 6, where it is considered that "[t]he new entities to be included in the list are corporate taxpayers in their Member State of residence *but some are considered on the basis of their legal characteristics to be transparent for tax purposes by other Member States. Member States treating non-resident corporate taxpayers as fiscally transparent* on this basis should grant the appropriate tax relief in respect of revenue which forms part of the tax base of the Parent company" (emphasis added).

27 In the context of the *Columbus Container Services Case* (Case C-298/05 Columbus Container Services [2007] ECLI:EU:C:2007:754), Fibbe and Stevens recall that the ECJ states that "Member States are *autonomous in classifying foreign entities* for general domestic tax purposes *as long as this autonomy is not effectuated in a manner that is discriminatory*" (emphasis added). *See* G. Fibbe and T. Stevens, 'The Approach to Hybrid Entities under Primary EU Law and in the EU Tax Directives', in G. Fibbe and T. Stevens (eds), *Hybrid Entities and the EU Direct Tax Directives* (Wolters Kluwer 2014), 11. *See*, in this regard, Case C-298/05 Columbus Container Services [2007] ECLI:EU:C:2007:754, para. 51. *See also,* Opinion of Advocate General Mengozzi in Case C-298/05 Columbus Container Services [2007] ECLI:EU:C:2007:197, para. 41: "At the current stage of development of Community law, it does not require Member States to recognise in their territory the legal and tax status afforded by the domestic law of the other Member States to entities carry out their domestic activity there". *See also,* J. Calderón and A. Báez, 'The Columbus Container Services ECJ Case and Its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-discrimination Principle' (2009) Intertax, issue 4, 221-222.

28 Although in a whole different context related to a non-listed entity in the PSD at that time, it is worth recalling that the CJEU stated that the PSD "does not seek to introduce a common system for all companies of the Member States nor for all holdings". *See* Case C-247/08 *Gaz de France* [2009] ECLI:EU:C:2009:600, para. 36. To Boulogne and Geursen, "the ECJ should have concluded that only entities that are not subject to corporate income tax on the profits received were to be excluded from the scope of the Directive". *See* F. Boulogne and W. Geursen, 'Gaz de France: Dividends to Companies Not Listed in the Parent-Subsidiary Directive Are Not Exempt' (2010) European Taxation, issue 4, 134. *Ibid,* 140. *See also,* in this regard, Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, of 23 October 2001, Towards an Internal Market without tax obstacles A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities, COM(2001) 582, 12: "the Directives' [PSD and Merger Directive] scope should include all entities subject to company tax".

29 "In outbound situations, Member States can differ of opinion who the profit generating entity is; the Parent company or its hybrid subsidiary. In inbound situations, where a dividend is paid to a hybrid entity, Member States can differ of opinion about the question to whom the dividend is paid: the hybrid entity or its participants". *See* T. Stevens and G. Fibbe, 'Taxation of hybrid entities under the Parent-Subsidiary Directive: The example of the Netherlands' (2011) EC Tax Review, issue 5, 242. According to Picariello, "[t]he outbound situation considers when a taxpayer of a MS makes an investment in a foreign entity while the inbound situations refer to when a foreign entity invests in a company in another MS". *See* S. Picariello, 'Hybrid entities and their treatment under the Parent-Subsidiary Directive and the Interest and Royalty Directive', in S. Govind & J.-P. Van West (eds.), *Hybrid Entities in Tax Treaty Law* (Linde 2020), 534. Calderón and Báez summarize such dichotomy by identifying 'inbound situations' to "source state

Amending Directive 2003/123 only cared about those instances in which the jurisdiction of the parent entity is the one qualifying the subsidiary as transparent (outbound situation), while ignoring those situations in which the jurisdiction of the subsidiary is the one qualifying the parent entity as transparent (inbound situation).[30]

2. Article 4(2) PSD: a partial solution to DT in outbound situations

Article 4(2) PSD is meant to provide a partial solution to the potential double taxation deriving from the different qualification of a subsidiary by both the jurisdiction of the parent entity and the jurisdiction where the subsidiary is located. It deals with a situation where the subsidiary is a *direct hybrid entity*,[31] meaning that it is non-transparent and thus liable to taxation in the jurisdiction where it is located, but the jurisdiction of the parent company qualifies and treats it as transparent for tax purposes as explained and depicted in the example of Figure 6.2 *supra*. Fibbe and Stevens give an example in which "[t]he state of the subsidiary taxes the earning of the profits and the distribution of the profits in the hands of the subsidiary, while the state of the parent company only taxes one event, the earning of the profits in the hands of the **6.016**

treatment of non-residents" and 'outbound situations' to "home state treatment of residents performing cross-border activities". *See* J. Calderón and A. Báez, 'The Columbus Container Services ECJ Case and Its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-discrimination Principle' (2009) Intertax, issue 4, 214.

30 *See* G. Fibbe and T. Stevens, 'Comparative Analysis, Conclusions and Recommendations', in G. Fibbe and T. Stevens (eds), *Hybrid Entities and the EU Direct Tax Directives* (Wolters Kluwer 2014), 259: "Contrarily to outbound situations [. . .], for the application of the PSD to hybrid entities in inbound situations, no specific provisions relating to hybrid entities are included in the Directive". *See,* for a note on the issue of hybrid entities in inbound situations within the Directive, *infra* section C.

31 *See supra* section B.1. *Reverse hybrid entities* in outbound situations are out of Article 4(2) and the Directive does not provide a solution to any potential outcome of double taxation that may stem from it. See, in this regard, *infra* section C. See, on the concept of *reverse hybrid entities, supra* section B.1. In this case, it is the jurisdiction of the subsidiary the one qualifying the very subsidiary as fiscally transparent, while the jurisdiction of the Parent entity qualifies the subsidiary as non-transparent and liable to taxation in the jurisdiction where the subsidiary is located. *See,* for further detail on this reverse hybrid entities in outbound situations, G. Fibbe and T. Stevens, 'The Approach to Hybrid Entities under Primary EU Law and in the EU Tax Directives', in G. Fibbe and T. Stevens (eds), *Hybrid Entities and the EU Direct Tax Directives* (Wolters Kluwer 2014), 15. The only concern that may arise in this case in terms of double taxation would relate to any potential taxation of the profits (earnings or income) in the hands of the partners or the very transparent entity according to tax law in the jurisdiction of the subsidiary. To Picariello, it is understandable that the PSD does not deal with reverse hybrid entities in outbound situations "since the company [the subsidiary] will not meet the criteria to qualify as a 'company of an MS' under Article 2(a)(iii) of the PSD [. . .][and], under the laws of several MSs, the company [subsidiary] would not be regarded as a tax resident company", most likely not qualifying under Article 2(a)(ii). *See* S. Picariello, 'Hybrid entities and their treatment under the Parent-Subsidiary Directive and the Interest and Royalty Directive', in S. Govind & J.-P. Van West (eds.), *Hybrid Entities in Tax Treaty Law* (Linde 2020), 535.

parent company".[32] Dealing with such an issue, Article 4(2) PSD is divided into two parts dealing with (i) the possibility for parent jurisdictions to qualify and treat entities ("subsidiaries") located in a different Member State as fiscally transparent according to its own law, taxing the profits accordingly, and (ii) the method(s) and requisites for the avoidance of double taxation at the level of the parent, if that is the case.

(a) Article 4(2)(1) PSD: the prevalence of the domestic qualification and the taxation thereof

6.017 Article 4(2)(1) PSD confirms the possibility for Member States where parent entities are located to qualify a non-resident subsidiary located in a different Member State as fiscally transparent according to their own domestic legal parameters. Indeed, this first paragraph of the article confirms the autonomy of Member States where parent entities are located regarding the qualification of companies for the purposes of the Directive by stating that *nothing in this Directive shall prevent* them to do that. This inherently leads to a conflict of qualification and to a most likely – if not certain – outcome of double taxation that the very provision tries to overcome in the second paragraph to ensure compliance with the main objective of the PSD.[33] The commentary on Article 4(2)(1) PSD may be dissected in three main parts as (i) the autonomy to qualify of subsidiaries as fiscally transparent, (ii) the taxation of the share of profits made by the subsidiary at the level of the parent according to that qualification, and (iii) the limitation on Member States where the parent entities are located to tax any distributed profits of the subsidiary.

6.018 With respect to the first part of the paragraph, it is worth highlighting that this permission for the Member State of the parent entity to autonomously qualify the subsidiary located in a Member State as fiscally transparent is related to an assessment of the *legal characteristics of the subsidiary*. Certainly, the parent entity must assess the *legal characteristics of* the subsidiary based on the law of the Member State where it is incorporated. This means that the parent company needs to dig into such *legal characteristics arising from the law* where the subsidiary is constituted in order to ascertain whether, according to its own law, the subsidiary qualifies as fiscally transparent. In a nutshell, and figuratively speaking, the Member State of the parent moves the subsidiary into its domestic law framework and assesses whether those *legal* characteristics

32 *See* G. Fibbe and T. Stevens, 'Comparative Analysis, Conclusions and Recommendations', in G. Fibbe and T. Stevens (eds), *Hybrid Entities and the EU Direct Tax Directives* (Wolters Kluwer 2014), 250.

33 *See infra* section C.2.b.

arising from the law of the Member State of the subsidiary would made the entity a transparent entity or not.

Nevertheless, it is important to keep in mind that there is an actual reference to *legal characteristics* that may lead to qualify the subsidiary as fiscally transparent, excluding potential fiscal transparency related to specific tax regimes such as CFC rules. In the words of Russo, and for that very reason, "[a]ny reference to the companies of a Member State treated as transparent by another Member State on the basis of the tax regime applying to these companies in their residence Member State [. . .][was] deliberately avoided".[34] In this regard, Member States would not be constrained or limited to apply domestic tax regimes such as CFC rules by means of Article 4(2) PSD that may lead to the transparency of the subsidiary for domestic tax purposes in the Member State of the parent.[35] **6.019**

Having said that, one could be forgiven for raising the question of what may happen if the qualification of non-resident entities from a domestic perspective is not actually based on the legal characteristics, but rather on an assessment of the tax treatment provided by the jurisdiction where the subsidiary is located in order to consider it as transparent or non-transparent in the Member State of the parent. There does not seem to be much room for deviating from the analysis of the *legal characteristics* and take into account any fiscal criterion instead. To Russo, "[t]he reference to the legal characteristics of the entity *excludes the relevance of any fiscal criteria* so as to characterize the foreign entity".[36] Nevertheless, there is no impediment for a Member State to qualify foreign entities as transparent or non-transparent according to the domestic tax regime that an entity is subject to in the jurisdiction where it is incorporated, as is the controversial case of Spain. In any case, this Spanish "tax **6.020**

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34 *See* R. Russo, 'Partnerships and other hybrid entities and the EC corporate direct tax Directives' (2006) European Taxation, issue 10, 479. *See also* G. Maisto, 'The 2003 amendments to the EC Parent-Subsidiary Directive: What's next?' (2004) EC Tax Review, issue 4, 175: "transparency derived from the application of CFC rules current in the State of residence of the Parent is not included in the scope of the new paragraph"; and *also* M. Tenore, 'Taxation of Dividends: A Comparison of Selected Issues under Article 10 OECD MC and the Parent-Subsidiary Directive' (2010) Intertax, issue 4, 225.

35 *See* O. Marres, 'The Parent-Subsidiary Directive', in B. Terra and P. Wattel (eds), *European Tax Law* (7th edition, Wolters Kluwer 2022), 553: "In order to avoid that Member States applying CFC legislation [. . .] might be hindered by the Directive in applying such legislation, Article 4(2) refers to the Parent company State's 'assessment of the *legal* characteristics of that company *arising from the law under which it is constituted*'" (Marres' emphasis).

36 *See* R. Russo, 'Partnerships and other hybrid entities and the EC corporate direct tax Directives' (2006) European Taxation, issue 10, 486.

resemblance test", which has been extensively criticised,[37] would not interfere either with tax regimes such CFC rules because the latter do not actually focus on the tax transparency of the entity where it is incorporated.

6.021 Once it is settled that the Member State of the parent qualifies the subsidiary as fiscally transparent, Article 4(2)(1) PSD recognises the taxation of the share of the profits of the subsidiary at the level of the parent *as and when those profits arise* without the need of an actual distribution. Article 4(2)(1) PSD ascertains that the parent entity may qualify the subsidiary as transparent and thus tax the profits it made in line with – and with no restriction from – the Directive. The qualification of the subsidiary as transparent and the taxation of its profits at the level of the parent entity are tied together.

6.022 Lastly, the first paragraph also seems to avoid double taxation so by impeding the Member States of the parent company to tax any distributed profits of the subsidiary (and this notwithstanding that it is the second paragraph of Article 4(2) PSD that is dedicated to the avoidance of double taxation due to the conflict of qualification in some outbound situations). At first sight, this seems completely logical, but on closer inspection it is less logical. On the one hand, it is reasonable to prevent Member States of the parent company from taxing profits of the subsidiary upon distribution if those profits have been already taxed at the level of the parent company *as and when they* arose. On the other hand, however, if the subsidiary is fiscally transparent in the eyes of the Member State of the parent entity, there is no possible distribution of profits from the subsidiary to the parent entity from the point of view of the parent. Although there is an actual distribution of profits from the perspective of both the Member State of the subsidiary and the subsidiary itself,[38] it is understandable that such a distribution of profits is disregarded beforehand

37 The tax resemblance test has been upheld by the Spanish Tax Administration despite the fact that the Spanish non-resident income tax clearly relies on the legal nature of the foreign entity and not on its tax treatment in order to qualify entities as transparent or not for non-resident tax purposes. *See* ES: *Resolución de 6 de febrero de 2020, de la Dirección General de Tributos, sobre la consideración como entidades en régimen de atribución de rentas a determinadas entidades constituidas en el extranjero*. Vega Borrego is of the opinion that the assessment of a foreign entity as transparent or non-transparent according to the non-resident income tax law must be based on legal characteristics of the entity according to the commercial and civil legislation in the jurisdiction where the foreign entity is located as for its comparison with domestic entities. *See* F. Vega Borrego, 'La calificación de las entidades extranjeras como transparentes o no transparentes en los impuestos sobre la renta' (2015) Revista Jurídica de la Universidad Autónoma de Madrid, issue 31, 455.

38 The subsidiary also qualifies as non-transparent and liable in the Member State where it is located, and it might therefore be under the scope of the Directive if the rest of requisites for it are fulfilled. In fact, and notwithstanding the analysis carried out with respect to reverse hybrid entities in inbound situations in *infra* section C, the subsidiary is bound by Art. 5 PSD and by the exemption from withholding tax on the distribution of profits laid down in it, consequently.

from the perspective of the Member State of the parent and the parent entity itself.[39] Having said that, it has been already considered that the true measure of the PSD for the avoidance of double taxation in certain outbound situations whenever a hybrid entity is at stake is provided for in paragraph 2 of Article 4(2).

(b) Article 4(2)(2) PSD: the avoidance of double taxation

Article 4(2)(2) PSD lays down the two classic methods for the avoidance of double taxation within the Directive (i.e., the exemption method and the indirect credit method), but in this case related to the double taxation that may arise whenever the Member State of the parent entity assesses and taxes that entity's share of the profits of the subsidiary *as and when* they arise. This is not different from the methods for the avoidance of double taxation at the level of the parent entity laid down in Article 4(1) PSD,[40] except for the fact that in this case there is no distribution of profits from the subsidiary, but rather an attribution of the profits of the subsidiary by the parent entity as already discussed.[41] **6.023**

In this regard, it is worth reminding that, no matter the qualification of the subsidiary as a transparent entity by the Member State of parent, the subsidiary is actually non-transparent and liable to tax in the Member State where it is located. Again, the subsidiary is a *direct hybrid entity* and will be taxed for the profits it makes in the Member State where it is present leading to double taxation if the parent entity assesses the profits and tax them according to its own corporate income tax at the same time. That is why Article 4(2)(2) PSD and the explicit consideration of the two methods for the avoidance of double taxation are that important for achieving the goals of the Directive in this **6.024**

39 To Russo, this limitation on taxing profits upon distribution at the level of the Parent entity "appears to be meaningless [. . .] [since the Member State of the Parent] does not recognize any profit distribution for tax purposes". *See* R. Russo, 'Partnerships and other hybrid entities and the EC corporate direct tax Directives' (2006) European Taxation, issue 10, 480. He concludes that, "from the perspective of the Parent's Member State, the subsidiary is fiscally transparent and, therefore, *no profit distribution can be conceived for tax purposes*" (emphasis added). *Id. See also* A. Lamers and T. Stevens, 'Classification Conflicts: The Cross-Border Tax Treatment of the Profit Share of Limited Partners' (2004) European Taxation, issue 4, 162.

40 *See,* for the analysis of the exemption and indirect credit method in Article 4(1) PSD, *supra* (Chapter 5).

41 *See supra* section C.2.a. "The Parent company State does not await distribution, but taxes the Parent company for its share of the subsidiary's undistributed profits as and when that profits arise, as if the Parent were a partner in a partnership rather than a shareholder in a separate legal entity". *See* O. Marres, 'The Parent-Subsidiary Directive', in B. Terra and P. Wattel (eds), *European Tax Law* (7th edition, Wolters Kluwer 2022), 552.

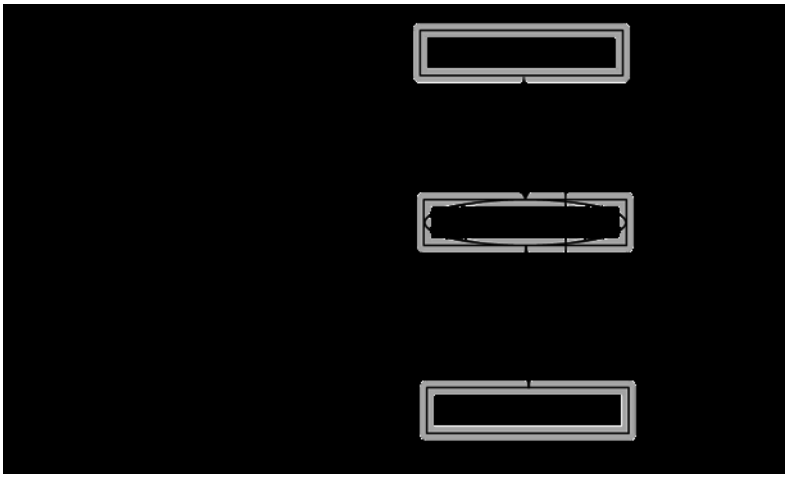

Figure 6.4 Reverse hybrid entity – inbound situation

particular case where there is no need of a distribution of profits for the parent entity to tax the profits of the subsidiary.[42]

D. BEYOND ARTICLE 4(2) PSD: A BRIEF NOTE ON INBOUND SITUATIONS AND (REVERSE) HYBRID ENTITIES

6.025 Article 4(2) PSD exclusively deals with hybrid entities in a particular outbound situation as already considered, but there is no solution to other potential issues that may stem from conflicts of qualifications related to hybrid entities within the Union.[43] One of the examples relates to reverse hybrid entities in inbound situations.[44] Figure 6.4 below shows the situation in which a Member State qualifies an entity [Entity B] as fiscally transparent, with entity C located in jurisdiction C being its only partner, whereas the Member State of the subsidiary qualifies the parent entity (entity B) as non-transparent. Entity C participates 100% in B and entity B participates 100% in entity A. The question in

42 *See,* with respect to the obligation of the Member State of the Parent to refrain from taxes any distribution of profits by the subsidiary-hybrid entity, *supra* section C.2.a *in fine*. It is worth mentioning that the credit method also relates to *"any lower-tier subsidiary, subject to the condition that each tier a company and its its lower-tier subsidiary fall within the definitions laid down in Article 2 and meet the requirements provided for in Article 3, up to the limit of the amount of the corresponding tax due*". See, again for further analysis of the methods under Article 4(1) PSD, *supra* (Chapter 5).

43 *See supra* footnote 30. *See also* S. Picariello, 'Hybrid entities and their treatment under the Parent-Subsidiary Directive and the Interest and Royalty Directive', in S. Govind & J.-P. Van West (eds.), *Hybrid Entities in Tax Treaty Law* (Linde 2020), 536.

44 *See,* with respect to the concept of *reverse hybrid entities* and *inbound situations*, *supra* Section A.

this case is whether entity A shall apply the Directive, and particularly, Article 5 PSD to a distribution of profits to entity B if both entities are listed as companies as for Article 2(a)(i) PSD.[45]

A diagram showing entity P, established in jurisdiction C, which may or may not be an EU Member State. Entity C holds a participation in entity B which is established in jurisdiction B, an EU Member State. In turn, entity B holds a participation in entity A which is established in jurisdiction A, another EU Member State. Both jurisdiction C and jurisdiction B consider entity B to be transparent. Jurisdiction A considers both entity A and entity B to be non-transparent. Entity A distributes a dividend. That dividend may, depending on the interpretation, be attributed to either entity B or entity C. **6.026**

Article 5 PSD seems to leave little room – if any – for the application of the withholding tax exemption in case that entity B, although listed as a company for the purposes of PSD, attributes the dividends – and their taxation thereof, if that is the case – to the partner entity C (non-transparent) located in a different jurisdiction because of its tax transparency in jurisdiction B. Strictly speaking, that would mean that entity B does not qualify as a (parent) company for the purposes of the PSD since it is not subject to tax due to its transparent character.[46] In this regard, it is necessary to consider two different situations separately: either entity C (the partner/parent) is located in a Member State, or it is located in a third jurisdiction. With respect to the latter, it does not seem to be possible to get access to the benefits of the PSD since entity C would never be considered to fall within the scope of the directive. If entity C is located in a Member State and it is actually a non-transparent entity subject to taxation in jurisdiction C,[47] an outcome of double taxation will (most) likely arise, potentially clashing with the objective and purpose of the PSD. Although in the context of a different situation,[48] yet relevant to the issue at stake here, it has been considered that the withholding tax exemption should be granted if the partners qualify as companies of Member **6.027**

45 *See,* for an analysis from a Dutch perspective, T. Stevens and G. Fibbe, 'Taxation of hybrid entities under the Parent-Subsidiary Directive: The example of the Netherlands' (2011) EC Tax Review, issue 5, 246-248.

46 *See* Article 2(a)(iii) PSD. *See,* for further analysis on the concept of company and the subject to tax requirement, *supra* (Chapter 4).

47 This situation would remain also in the case in which entity C were located in the same jurisdiction as the transparent entity B with minor nuances.

48 *See* Case C-448/15 Wereldhave Belgium [2017] ECLI:EU:C:2017:180. In a nutshell, the case deals with the application of the withholding tax exemption of Article 5 PSD and the status of company with respect to the requisite of subject to taxation whenever there is a zero tax rate at the level of the Parent entity and an automatic redistribution of profits to a higher level Parent entity (see also Chapter 3, Section C.3).

States within the PSD in order to be in line with the object and purpose of the Directive in terms of the avoidance of double taxation.[49] Still, there does not seem to be any obligation from the wording of the PSD for Member States to apply Article 5 in these situations, potentially leading to double taxation.

E. IN A NUTSHELL

6.028 Article 4(2) PSD deals with one specific issue related to hybrid entities in certain outbound situations. In particular, the provision intends to avoid double taxation stemming from the qualification of a subsidiary as non-transparent by the Member State where it is incorporated and as transparent by the Member State of the parent entity. In doing so, this provision confirms the autonomy of Member States (particularly the Member States where a parent company is established) to qualify foreign entities as well as to allocate to themselves and tax the profits generated by subsidiaries *as and when* they arise. Given that such an allocation may certainly lead to double taxation since the subsidiary is still taxed where it is incorporated as a non-transparent entity, Article 4(2) PSD obliges the Member State of the parent entity to grant a method for the avoidance of such double taxation. Nevertheless, double taxation outcomes related to hybrid entities and conflicts of qualification still remain in different outbound and inbound situations.

49 *See*, among others, and although with different approaches, P. Arginelli, 'The Subject-to-Tax Requirement in the EU Parent-Subsidiary Directive (2011/96)' (2017) European Taxation, issue 8, 337; D.J. Jiménez-Valladolid de L'Hotellerie-Fallois, 'Interpretación de la cláusula «subject-to-tax» en la directiva matriz-filial: ¿Basta con la mera sujeción o es necesaria tributación efectiva? Análisis de la STJUE de 8 de marzo de 2017, Belgische Staat contra Wereldhave Belgium Comm. VA y otros (asunto C-448/15)' (2017) Nueva Fiscalidad 2, 216-217; O. Marres, 'The Parent-Subsidiary Directive', in B. Terra and P. Wattel (eds), *European Tax Law* (7th edition, Wolters Kluwer 2022), 530-531. *See also* T. Stevens and G. Fibbe, 'Taxation of hybrid entities under the Parent-Subsidiary Directive: The example of the Netherlands' (2011) EC Tax Review, issue 5, 252.

7

ARTICLE 5–7: TAXATION OF OUTBOUND DIVIDENDS

Cees Peeters

ARTICLE 5

Profits which a subsidiary distributes to its parent company shall be exempt from withholding tax.

ARTICLE 6

The Member State of a parent company may not charge withholding tax on the profits which such a company receives from a subsidiary.

ARTICLE 7

1. **The term 'withholding tax' as used in this Directive shall not cover an advance payment or prepayment (précompte) of corporation tax to the Member State of the subsidiary which is made in connection with a distribution of profits to its parent company.**
2. **This Directive shall not affect the application of domestic or agreement-based provisions designed to eliminate or lessen economic double taxation of dividends, in particular provisions relating to the payment of tax credits to the recipients of dividends.**

COMMENTARY

A. GENERAL INTRODUCTION

7.001 The common denominator of Articles 5, 6, and 7 of the PSD is the prohibition to impose a withholding tax on qualifying dividend distributions. As such, these provisions give substance to paragraph 1(b) of the Preamble of the Directive[1]: "Each Member State shall apply this Directive:" – "(b) to distributions of profits by companies of that Member State to companies of other Member States of which they are subsidiaries";[2] Article 5 imposes this obligation on the Member State of the subsidiary, whereas Article 6 ensures – to be on the safe side – that also the Member State of the parent company will not impose a withholding tax on qualifying dividend distributions. Article 7 elaborates on what should not be regarded as a withholding tax. This provision is specifically targeted at imputation systems which have become less relevant over time.

7.002 The CJEU attaches great importance to the object and purpose of the Directive in its case law about the interpretation of these three provisions.[3] It is therefore

1 Council Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States of 30 November 2011, O.J. 2011 L 345/8.

2 Paragraph 1(b) of the Preamble of Council Directive 2011/96/EU.

3 This will be clear from the critical overview of Articles 5, 6 and 7 in the forthcoming paragraphs. There are many references to this object and purpose in the relevant case law of the CJEU. Compare, for example: Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495, para 45 (with references to earlier case law), Joined Cases C-338/08 and 338/09, P. Ferrero e C. SpA vs. Agenzia delle Entrate – Ufficio di Alba and General Beverage Europe BV vs. Agenzia delle Entrate – Ufficio di Torino 1, [2010] ECLI:EU:C:2010:364, para 23 and Case C-257/20 Viva Telecom Bulgaria [2022] ECLI:EU:C:2022:125, paras 59-61.

useful to address this matter in somewhat greater detail. The preamble of the current Directive is very instructive in this regard. Paragraph 3 of this preamble makes clear that "(t)he objective of this Directive is to exempt dividends and other profit distributions paid by subsidiary companies to their parent companies from withholding taxes".[4] This objective of the Directive should be instrumental to the formation of groups of companies from different Member States, which is – in its turn – needed "to create within the Union conditions analogous to those of an internal market and in order thus to ensure the effective functioning of such an internal market".[5] Paragraph 6 provides some more historical context on the hindering role of taxation in this regard.[6] It alludes to the substantial differences between the tax systems of the Member States before the introduction of the PSD in 1990.[7] For this matter, it makes clear that "the tax provisions governing the relations between parent companies and subsidiaries of different Member States (. . .) were generally less advantageous than those applicable to parent companies and subsidiaries of the same Member State".[8]

The tangible elucidation of this object and purpose of the Directive for the specific prohibition to impose a withholding tax on qualifying dividends is the prevention of economic double taxation.[9] Advocate-General Tizzano was very clear about this purpose of Article 5 when he wrote in his opinion on the *Océ van der Grinten* case that "(t)he purpose of that provision (. . .) is the elimination or lessening of economic double taxation of profits distributed by a subsidiary company to a parent company".[10] The provision should therefore establish that the state of the subsidiary does not levy "a second layer of tax" – payable by the parent company – on top of the corporate income tax that is levied from the subsidiary.[11] **7.003**

This chapter will also pay attention to the historical development of the three discussed provisions of the PSD. In this context, it is already instructive to note that the current Articles 5 and 6 were already part of the first version **7.004**

4 Paragraph 3 of the Preamble of Council Directive 2011/96/EU.
5 Paragraph 4 of the Preamble of Council Directive 2011/96/EU. Also compare paragraph 5.
6 Paragraph 6 of the Preamble of Council Directive 2011/96/EU.
7 *Ibid*.
8 *Ibid*.
9 Compare M. Helminen, 'Dividend equivalent benefits and the concept of profit distribution of the EC Parent-Subsidiary Directive' (2000) EC Tax Review, issue 3, 162.
10 Opinion of Advocate General Tizzano, 23 January 2003, Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495, para 29.
11 See M. Tenore, 'The Parent-Subsidiary Directive', in M. Lang et al. (eds.), Introduction to European Tax Law on Direct Taxation (Linde 2024), no. 459.

of the PSD. As a matter of fact, the wording of the current Article 6 has not changed at all ever since. There is no such stability when it comes to the text of Article 5. There are some significant differences between the 1969 draft version of this provision and the text of the version that was eventually adopted in 1990. Section B.1 will briefly deal with these changes and also address the amendments that were made to Article 5 by means of Council Directive 2003/123/EC of 22 December 2003. The current Article 7 was already part of the 1990 Directive and has not changed since.[12]

B. ARTICLE 5 PSD

7.005 The current text of Article 5 is brief and to the point: "(p)rofits which a subsidiary distributes to its parent company shall be exempt from withholding tax". Article 5 is therefore a clear example of "exhaustive harmonisation" in the sense that it plainly sets forth, as described by Korving, "the conditions of application of the directive and leave(s) Member States no room not to grant the withholding tax exemption to situations falling within the scope of the directive".[13] It is actually for this reason that Harris named this obligatory exemption from withholding tax for qualifying dividends as the "single most important provision" of the PSD.[14] At the time of introduction, this provision resulted in "a departure from current practice in both double taxation treaties and national legislation".[15]

7.006 It is the purpose of this section to describe and analyse the interpretation of Article 5 in great detail. Section B.1 deals with the history of Article 5, section B.2 focuses on the interpretation of "profits which a subsidiary distributes to its parent company", while section B.3 covers the interpretation of the term "withholding tax".

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12 At this point, it is noteworthy to add that the establishment of Article 7(2) was the subject of the Océ van der Grinten case. The taxpayer argued that this provision was invalid, since the Economic and Social Committee and the European Parliament were not consulted about the introduction of this provision. After all, the 1969 draft version of the PSD – for which the Economic and Social Committee and the European Parliament were consulted – did not contain any Article 7. The CJEU rejected this argument of the taxpayer. Compare Court of Justice 25 September 2003, Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495, paras 90-103.

13 J. Korving, 'The European Triangle: On the Relationship between Primary EU Law, Secondary EU Law and National Law in the Field of Direct Taxation' (2024) European Business Law Review, 32.

14 C. Harris, 'The European Community's Parent-Subsidiary Directive' (1992) Florida Journal of International Law, 137.

15 *Ibid.*

1. History of Article 5 PSD

The current version of Article 5 PSD consists of a single paragraph which provides for the exemption of withholding tax in an unconditional way. This has, however, only been the case since the 2003 amendment of the Directive. The original 1990 version of Article 5 consisted of four paragraphs.[16] It is instructive to reconstruct this history in somewhat more detail in order to obtain a better understanding of the provision. **7.007**

This narrative about the evolution of Article 5 starts with the (already-mentioned) very first version of the PSD. That 1969 draft already had the contours of the current provision. It provided for an exemption of withholding tax conditional upon a shareholding of at least 20%. The most remarkable aspect of this draft was probably the specific definition of the particular withholding taxes in the (then) six Member States. This definition will be addressed in some more detail in section B.3 below. **7.008**

It is well-known that it has taken the Member States, as explained in Chapter 1, a long period of time to find an agreement about the PSD. The very wording of Article 5 of the 1990 version illustrates that the Member States had to reach a compromise on some issues.[17] The paragraphs 2, 3, and 4 eventually provided for some Member State-specific exceptions to the general rule, as laid down in paragraph 1, that qualifying distributions of profit should be exempt from withholding tax. There were exceptions for Greece (in paragraph 2),[18] Germany (in paragraph 3),[19] and Portugal (in paragraph 4).[20] The preamble of the Directive made clear that Portugal obtained the exception for budgetary **7.009**

16 Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States of 23 July 1990, O.J. 1990 L 225/6.

17 More detail on the points of discussion can also be found in a Communication from the Commission to the Council of 5 July 1985. The compromise version of Article 5 that can be found in this document differs from the provision that was eventually adopted in 1990. See Commission of the European Communities, Fiscal measures aimed at encouraging cooperation between undertakings of different Member States, 5 July 1985, COM(85) 360 final.

18 The text of Article 5(2) reads as follows: "Notwithstanding paragraph 1, the Hellenic Republic may, for so long as it does not charge corporation tax on distributed profits, levy a withholding tax on profits distributed to parent companies of other Member States. However, the rate of that withholding tax must not exceed the rate provided for in bilateral double-taxation agreements".

19 The text of Article 5(3) reads as follows: "Notwithstanding paragraph 1, the Federal Republic of Germany may, for as long as it charges corporation tax on distributed profits at a rate at least 11 points lower than the rate applicable to retained profits, and at the latest until mid-1996, impose a compensatory withholding tax of 5% on profits distributed by its subsidiary companies".

20 The text of Article 5(4) reads as follows: "Notwithstanding paragraph 1, the Portuguese Republic may levy a withholding tax on profits distributed by its subsidiaries to parent companies of other Member States until a date not later than the end of the eighth year following the date of application of this Directive.

reasons, while Greece and Germany obtained the special position because of the fact that they were relying on a split-rate corporate income tax system.[21] The preamble also emphasised that these three Member States were allowed to maintain a withholding tax on a temporary basis only. Accordingly, the 2003 amendment of the Directive provided for the abolition of Articles 5(2), 5(3) and 5(4).[22]

7.010 Another aspect of the 1990 version of Article 5 that should be addressed is the conditionality of the withholding tax exemption in paragraph 1. The provision explicitly emphasised that the parent company was supposed to hold at least 25% of the capital of the subsidiary in order for the exemption to be applicable.[23] This conditionality was obviously rather remarkable, since this criterion was already addressed by the definition of "parent company" in Article 3(1)(a) of that Directive.[24] It is therefore not very surprising that this criterion was eliminated with the 2003 Amendment of the PSD.[25] As from that moment, the text of Article 5(1) has not changed anymore. This text is, in other words, not affected by the recasting of the PSD in 2011 and by the subsequent amendments of that 2011 Directive.

7.011 In this historical overview of Article 5, there should also be some attention to the temporary derogation for Estonia. Estonia obtained a derogation from the application of Article 5 upon joining the European Union in 2004.[26] This

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Subject to the existing bilateral agreements concluded between Portugal and a Member State, the rate of this withholding tax may not exceed 15% during the first five years and 10% during the last three years of that period.

Before the end of the eighth year the Council shall decide unanimously, on a proposal from the Commission, on a possible extension of the provisions of this paragraph".

21 It is outside the scope of this chapter to elaborate in greater detail on these exceptions and on the somewhat imprecise wording of paragraphs 2-4. More details can be found in F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 434 and C. Harris, 'The European Community's Parent-Subsidiary Directive' (1992) Florida Journal of International Law, 138-139.

22 See Article 5(b) of Council Directive 2003/123/EC amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States of 22 December 2003, O.J. 2004 L7/41-44.

23 The text of Article 5(1) reads as follows: "Profits which a subsidiary distributed to its parent company shall, at least where the latter holds a minimum of 25% of the capital of the subsidiary, be exempt from withholding tax".

24 Accordingly, this text was criticised in academic literature. Lambooij, for example, writes that the function of this repetition is unclear. This author presupposes that it was actually a mistake. See M. Lambooij, 'De moeder-dochterrichtlijn en de Nederlandse wetgeving" (1994) FED, paragraph 7.

25 See Article 5(a) of Council Directive 2003/123/EC amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States of 22 December 2003, O.J. 2004 L7/41-44.

26 See Act of Accession, Annex VI (Estonia), chapter 7 (Taxation), section 2. The text reads as follows: "By way of derogation from Article 5(1) of Directive 90/435/EEC, Estonia may, for as long as it charges income tax on distributed profits without taxing undistributed profits, and at the latest until 31 December

derogation was introduced because the European Commission had doubts about the compatibility of Estonia's corporate income tax system as it applied at the time. The Estonian system provided for the imposition of corporate income tax on the subsidiary upon the distribution of profits to the shareholder, and the CJEU's judgment in the *Athenaïki* case raised the question – by the time of the accession – whether such taxation amounted to a "withholding tax" within the scope of Article 5.[27] Hence, Estonia was granted a derogation until 31 December 2008. At that time, Estonia adjusted its corporate income tax system to make sure that there could be no more doubts about the compatibility with Article 5. There was, however, some discussion in academic literature as to whether it was actually necessary to introduce the derogation.[28] In hindsight, and with the knowledge of the *Burda* judgment issued in 2008, it is indeed correct to argue that the granting of the derogation was actually not necessary.

2. Interpretation of "Profits which a subsidiary distributes to its parent company"

(a) General remarks

The first element of Article 5 constitutes the personal and material scope of the provision. It is applicable to "Profits which a subsidiary distributes to its parent company". The interpretation of these legal terms is obviously directly dependent on the interpretation of the other provisions in the Directive. The terms "parent company" and "subsidiary" are defined in Article 3 (in conjunction with Article 2) (Chapter 4). In addition, the term "distribution of profits" is introduced, but not defined, in Article 1 and subsequently relied upon in Article 4(1). This term, defining the material scope of Article 5, is explained in more detail in Chapter 5, so there is no further elaboration below. There are, however, two observations to be made about the interpretation of "distributions of profits" within the specific context of Article 5. These issues are addressed below. **7.012**

2008, continue to apply that tax to profits distributed by Estonian subsidiaries to their parent companies established in other Member States". The Act of Accession is published in O.J. L 236/17-930.

27 Compare L. Lehis e.a., 'The Compatibility of the Estonian Corporate Income Tax System with Community Law' (2008) Juridica International, 14-24.

28 See R. Zukowski, 'Estonian Corporate Income Tax and the European Union: The Implications' (2006) European Taxation, 128-130 and L. Lehis e.a., 'The Compatibility of the Estonian Corporate Income Tax System with Community Law' (2008) Juridica International, 14-24.

(b) Distribution upon the liquidation of a company

7.013 The first issue concerns the qualification of a distribution upon the liquidation of a subsidiary. Article 4 explicitly excludes distributed profits that are received upon the liquidation of the subsidiary (Chapter 5). This means that the Member State of which the parent company is a resident does not have to grant the benefits of the Directive for such distributed profits. There is, however, no such carve-out in Article 5. This implies that the Member State of which the subsidiary is a resident does have to grant the benefits of the Directive in this situation. There is no convincing explanation for this incongruence between Articles 4 and 5, but there is no doubt in academic literature that the benefits of Article 5 should also be granted to distributions upon the liquidation of a subsidiary.[29]

(c) Specific interpretation of "distribution of profits" for the purposes of Article 5?

7.014 Another matter is the view that the term "distribution of profits" should be defined more broadly for the purposes of Article 5 than for Article 4. As a matter of fact, the described qualification of a distribution upon the liquidation of a subsidiary is obviously pointing in such a direction. More generally, both Vanistendael and Farmer & Lyal address the somewhat different wording of both provisions.[30] Article 4(1) requires, as explained in Chapter 5, that the parent company receives distributed profits "*by virtue of the association of the parent company with its subsidiary*". This particular requirement is not included in Article 5. Consequently, Farmer & Lyal take the view that "all payments made out of post-tax profits" should be included in the scope of Article 5 to the extent that the source state qualifies the payment as such.[31] In this view, the interpretation of the term "distribution of profits" for the purposes of Article 4(1) should be more limited since the state of the parent company cannot be obliged to follow the qualification of the state of the subsidiary.[32] There is, however, no consensus in literature about this position. Bundgaard,

29 See F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 433; M. Lambooij, 'De moederdochterrichtlijn en de Nederlandse wetgeving" (1994) FED, paragraph 7; M. Helminen, 'Dividend equivalent benefits and the concept of profit distribution of the EC Parent-Subsidiary Directive' (2000) EC Tax Review, issue 3, 171; and See S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Kluwer Law International 2022), 442-443.

30 F. Vanistendael, 'The implication of the Parent/Subsidiary Directive in the EC – Comments on some unresolved questions' (1992) Tax Notes International, 599-619 and P. Farmer and R. Lyal, EC Tax Law (Clarendon Press 1994), 272-273.

31 P. Farmer and R. Lyal, EC Tax Law (Clarendon Press 1994), 273.

32 P. Farmer and R. Lyal, EC Tax Law (Clarendon Press 1994), 272.

for instance, writes that he "tends to favour the interpretation that there is no evidence supporting a substantive difference in meaning of the provisions".[33]

In any case, the specific – broader – interpretation for the purposes of Article 5 would be reflected in the treatment of deemed profit distributions (i.e. constructive dividends). In this regard, it is argued that such specific dividends qualify as a "distribution of profits" within the ambit of Article 5, but not within the scope of Article 4(1).[34] In this view, the state of the subsidiary has the possibility to adjust the taxable profit of the subsidiary so that it will not lose its taxing rights.[35] Consequently, the broad interpretation of Article 5 would make it possible to avoid economic double taxation, whereas the state of the subsidiary is not restricted from applying anti-avoidance measures.[36] **7.015**

Nevertheless, the CJEU does not seem to follow this interpretation. It decided in the *Viva Telecom* case that fictitious interest payments cannot be qualified as a "distribution of profits" within the scope of Article 5.[37] The argument of the Court was that there is no actual payment of interest so that there can be no "distribution of profits" either.[38] This particular decision has been criticised in academic literature for a variety of arguments.[39] Nonetheless, it does serve as a strong indication that the CJEU is not willing to qualify deemed profit distributions as a "distribution of profit" for the purposes of Article 5. As a matter of fact, the CJEU was explicitly referring to Article 1(1)(b) in its judgment, so there are reasons to believe that the decision concerns the material scope of the PSD as a whole.[40] Consequently, there is indeed no indication to believe the CJEU is interpreting the term "distribution of profits" in a specific way for the purposes of Article 5. **7.016**

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33 J. Bundgaard, 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1' (2010) European Taxation, issue 10, 450.

34 See P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 272-273 and G. Maisto, 'The 2003 amendments to the EC Parent-Subsidiary Directive: what's next?' (2004) EC Tax Review, issue 4, 177-178.

35 G. Maisto, 'The 2003 amendments to the EC Parent-Subsidiary Directive: what's next?' (2004) EC Tax Review, issue 4, 178.

36 Farmer and Lyal also point to the already-mentioned different wording of Articles 4 and 5. Article 4 requires that the parent company receives the profit distribution in its capacity as a shareholder, whereas Article 5 does not. This difference does affect the qualification of deemed profit distributions. See P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 273.

37 Case C-257/20 Viva Telecom Bulgaria [2022] ECLI:EU:C:2022:125.

38 Case C-257/20 Viva Telecom Bulgaria [2022] ECLI:EU:C:2022:125, para 63.

39 See S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Kluwer Law International 2022), 440 and S. Kostikidis and F. Striefler, 'Fictitious Interest and Dividends Under Tax Treaties and the EU Directives' (2022) EC Tax Review, issue 5, 251-259.

40 Case C-257/20 Viva Telecom Bulgaria [2022] ECLI:EU:C:2022:125, para 61.

3. Interpretation of "withholding tax"

(a) Introduction

7.017 The most contested issue with regard to Article 5 is the interpretation of the pivotal term "withholding tax". There is no general definition of this term in the provision, so the CJEU has been called upon various times to provide guidance. This case law will be outlined and analysed below in the sections C.2 and C.3.

7.018 It is insightful, though, to make two observations about the interpretation of the term "withholding tax" at the outset of this overview.

7.019 One aspect is that the term "withholding tax" was defined in the very first version of the PSD as it was published in 1969.[41] Article 5 of that draft specifically mentioned "roerende voorheffing" (for Belgium), "Kapitalertragsteuer" (for Germany), "retenue à la source" (for France), "ritenuta alla fonte" (for Italy), "retenue d'impôt" (for Luxembourg) and "dividendbelasting" (for the Netherlands).[42] Such an exhaustive overview of taxes is still a well-known aspect of the PSD (compare Annex I with the list of qualifying companies and corporate income taxes), but this list of withholding taxes was not adopted in 1990. Probably, this had to do with the accession of the United Kingdom and the relevance of imputation systems which made the distinction between corporate income taxes and withholding taxes more complicated.

7.020 The relevance of imputation systems also resulted in the introduction of Article 7.[43] In particular, Article 7(1) establishes that "(t)he term 'withholding tax' as used in this Directive shall not cover an advance payment or prepayment (précompte) of corporation tax". It has been argued that this negative definition is of relevance for the interpretation of the term "withholding tax" in Article 5.[44] Stavropoulos claims in this regard that "its scope is open to an unlimited number of qualifying taxes".[45] He argues that this could imply that, except for the specifically mentioned advance payment or prepayment (précompte), "other forms or variations of corporate income tax are, from the outset, not excluded"

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41 Proposal for a Council directive on the common system of taxation applicable to parent companies and their subsidiaries of different Member States, COM(1969) 6, O.J. 1969, C39/7. The original proposal is only available in Dutch, French, German and Italian.

42 It should be remembered that this version was not available in English.

43 This very provision was not included in the first 1969 draft of the PSD. We refer to section D of this chapter for a further elaboration of this provision.

44 Compare, for example, I. Stavropoulos, 'The EC Parent-Subsidiary Directive and the Decision of the European Court of Justice in Burda' (2009) European Taxation, 150.

45 *Ibid.*

from the scope of Article 5.[46] It is therefore not surprising that this somewhat fragile distinction between "withholding tax" and "corporate income tax" runs like a thread through the case law of the CJEU on the interpretation of Article 5.[47]

(b) Overview of case law

7.021 The very first time that the CJEU had to interpret the term "withholding tax" was in the *Epson* case back in the year 2000.[48] That case concerned the qualification of the Portuguese succession and donation tax[49] for the purposes of Article 5(4).[50] The CJEU took a material stance to resolve the matter. It decided firmly that Member States would be able to undermine the objective of the Directive if they could impose a tax with the same effects as a withholding tax even though they would label it in a different way.[51]

7.022 In particular, the CJEU ruled that the term "withholding tax" is "not limited to certain specific types of national taxation".[52] Then it maintained that the Portuguese tax was indeed not described as a withholding tax under national tax law, but it held that this naming does not preclude such qualification for the purposes of Article 5(4). For this matter, it set three criteria for the qualification as a "withholding tax". It concerns a tax (i.) "for which the chargeable event is the payment of dividends or of any other income from shares", (ii.) "the taxable amount is the income from the shares", and (iii.) "the taxable person is the holder of the shares".[53] On the basis of these criteria, the CJEU decided that the Portuguese succession and donation tax does indeed qualify as a withholding tax within the scope of the PSD.

7.023 The *Epson* case constituted the basis for the later judgments of the CJEU. It continued to stress and apply these three characteristics in its definition of "withholding tax" in cases such as *Océ van der Grinten*[54] and the joined

46 *Ibid*.
47 Compare M. Lang, 'ECJ case law on cross-border dividend taxation – recent developments' (2008) EC Tax Review, 72-73.
48 Case C-375/98 Epson Europe [2000] ECLI:EU:C:2000:302.
49 That is, the Imposto sobre as Sucessies e Doaçies (ISD). More details about this tax and an analysis of the judgment can be found in F. De Sousa Câmara, 'Parent-Subsidiary Directive: The Epson Case' (2001) European Taxation, 307-314.
50 Article 5(4) made it possible for Portugal to maintain a withholding tax during a transitional period. See section B.1.
51 Case C-375/98 Epson Europe [2000] ECLI:EU:C:2000:302, para 24.
52 Case C-375/98 Epson Europe [2000] ECLI:EU:C:2000:302, para 22.
53 Case C-375/98 Epson Europe [2000] ECLI:EU:C:2000:302, para 23.
54 Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495.

cases *Ferrero and General Beverage*.[55] This application implied, for example, in the *Océ van der Grinten* case, that the 5% tax on the dividend distribution did qualify as a "withholding tax", whereas the (combined) 5% tax on the tax credit did not.[56] After all, the tax on the tax credit was not imposed on the profits that were distributed by the subsidiary, so the income did not constitute income from shares.[57] For the same reason, the CJEU decided in the *Ferrero and General Beverage* cases that the Italian tax on the refund of the imputation tax (i.e. the "maggiorazione di conguaglio") did not qualify as a "withholding tax"[58] either.

7.024 A point of confusion has been the interpretation of one aspect of the definition of the CJEU. This concerns the third element of the definition being that "the taxable person is the holder of the shares". Both the *Athinaïki Zythopiia*[59] and the *Burda*[60] cases explicitly dealt with this aspect. These cases concerned the qualification as a "withholding tax", for the purposes of Article 5, of a tax that was due by the company that is distributing the profit (i.e. the subsidiary).

7.025 For this matter, it is important to stress that these two cases concerned the aftermath of the Greek and German split-rate corporate income tax systems.[61] As explained before, the derogations laid down in the original 1990 Directive allowed these two Member States to maintain a withholding tax on a temporary basis.[62] Such systems implied, after all that distributed profits were taxed at a lower corporate income tax rate than profits that were retained in the company.[63] The *Athinaïki* and *Burda* cases concerned a type of equalisation tax that was part of corporate income tax systems which still – albeit in a very different way – relied on a distinction between distributed and retained profits.[64] Such

55 Joined Cases C-338/08 and 338/09, P. Ferrero e C. SpA vs. Agenzia delle Entrate – Ufficio di Alba and General Beverage Europe BV vs. Agenzia delle Entrate – Ufficio di Torino 1, [2010] ECLI:EU:C:2010:364.

56 Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495, paras 47-60.

57 Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495, paras 55-56.

58 Joined Cases C-338/08 and 338/09, P. Ferrero e C. SpA vs. Agenzia delle Entrate – Ufficio di Alba and General Beverage Europe BV vs. Agenzia delle Entrate – Ufficio di Torino 1, [2010] ECLI:EU:C:2010:364, para 41. For this matter, the CJEU determined at the outset that this tax as such does not qualify as a "withholding tax". This issue is discussed below.

59 Case C-294/99 Athinaïki Zithopiia AE [2001] ECLI:EU:C:2001:505.

60 Case C-284/06, Finanzamt Hamburg-Am Tierpark vs. Burda GmbH [2008] ECLI:EU:C:2008:365.

61 The derogations of Article 5(2) – for Greece – and Article 5(3) – for Germany – were explicitly not applicable in both cases.

62 See section B.1.

63 Greece applied an extreme variant of such a system up until 1992. The corporate income tax rate on profits distributed to resident companies amounted to 0%. Instead, companies had to withhold taxes at substantial rates on behalf of the shareholders.

64 It is outside the scope of this Chapter to explain the relevant provisions of Greek and German corporate income tax law in greater detail. More information can be found in I. Stavropoulos, 'ECJ: Greek

equalisation taxes constituted a tax at the level of the subsidiary (i.e. not the shareholder) in order to ensure that low-taxed (foreign) profits were eventually subject to the appropriate amount of corporate income tax.

Interestingly, the CJEU reached different conclusions in both cases. It decided in the *Athinaïki* case that the Greek complementary corporate income tax *does* constitute a "withholding tax" within the meaning of Article 5.[65] In this regard, it followed the economic analysis of Advocate-General Alber.[66] That analysis implied that "(t)he economic effect of taxation of the subsidiary is tantamount to taxation of the parent company, since the tax – as is typical for withholding taxes – is retained, and paid directly to the tax authorities, by the company making the distribution".[67] **7.026**

The CJEU explicitly rejected this position eight years later in the German *Burda* case.[68] In this decision, the CJEU explicitly reaffirmed that it is an essential element of the definition of "withholding tax", for the purposes of Article 5, that "the taxable person must be the holder of the shares".[69] It merely regarded the German tax as a "corrective accounting mechanism" that is levied at the level of the distributing company rather than at the level of the shareholder.[70] Hence, it decided that the German equalisation tax *does not* constitute a "withholding tax" within the meaning of Article 5. The CJEU unequivocally repeated this position in the already-mentioned *Ferrero and General Beverage* cases that concerned a somewhat comparable Italian tax.[71] **7.027**

Income Tax Provision is a Withholding within the Meaning of the Parent-Subsidiary Directive' (2002) European Taxation, 94-98 and I. Stavropoulos, 'The EC Parent-Subsidiary Directive and the Decision of the European Court of Justice in Burda' (2009) European Taxation, 150-154.

65 A critical analysis of this judgment can be found in G. Rolle, 'Is corporate income tax a withholding tax? Some comments on the Athinaïki Zythopoiia case' (2003) EC Tax Review, 36-42.

66 Case C-294/99 Athinaïki Zithopiia AE [2001] ECLI:EU:C:2001:505, para 28.

67 Opinion of Advocate General Alber, Case C-294/99 Athinaïki Zithopiia AE [2001] ECLI:EU:C:2001:263, para 32.

68 Case C-284/06, Finanzamt Hamburg-Am Tierpark vs. Burda GmbH [2008] ECLI:EU:C:2008:365, para 62.

69 Case C-284/06, Finanzamt Hamburg-Am Tierpark vs. Burda GmbH [2008] ECLI:EU:C:2008:365, para 61. Interestingly, it adds that this is evident from the Court's case law "subsequent to Athinaïki Zithopoiïa". The CJEU outlined the three conditions for the qualification as a withholding tax in para 51.

70 Case C-284/06, Finanzamt Hamburg-Am Tierpark vs. Burda GmbH [2008] ECLI:EU:C:2008:365, paras 63-64.

71 Joined Cases C-338/08 and 338/09, P. Ferrero e C. SpA vs. Agenzia delle Entrate – Ufficio di Alba and General Beverage Europe BV vs. Agenzia delle Entrate – Ufficio di Torino 1, [2010] ECLI:EU:C:2010:364, paras 28-35. For this matter, it is relevant to add that this Italian equalisation tax had to ensure that a shareholder was not granted a tax credit for corporate income tax that had not been paid by the company distributing the profit.

7.028 Unfortunately, it is not easy to reconcile the different outcomes of the *Athinaïki* and *Burda* cases. Marres therefore concludes that the CJEU was probably wrong in the *Athinaïki* case and attempted to correct itself in the *Burda* case.[72] Advocate-General Kokott also seems to consider the Greek case as an outlier in the (otherwise) consistent body of case law of the CJEU.[73] Other scholars have been at pains to highlight subtle differences between the Greek and German taxes as an explanation for the different outcomes. One factor, as stressed by the CJEU[74] and Advocate-General Mengozzi,[75] would be that the German tax should be seen as a "corrective accounting mechanism" of the corporate income tax. Another consideration is that the Greek tax did not make it possible to offset low-taxed income and losses.[76] This would imply that this tax does not sufficiently resemble a "real" corporate income tax and has more characteristics of a withholding tax.[77] Another explanation could be that the German equalisation tax was an element of the German imputation system, whereas the Greek (complementary) tax was not.[78] This would imply that the German tax would anyway be compatible with Article 7(1), whereas the Greek tax was definitely not.[79]

7.029 Either way, the CJEU has persistently attached decisive relevance to the taxable person in its case law following the *Burda* judgment. This was particularly the case in decisions on the compatibility of so-called "fairness taxes" in Belgium and France with Article 5.[80] Such taxes constitute an additional tax on top of the regular corporate income tax which is levied on profit distributions.[81] Formally speaking, the taxpayer is the company that distributes the profit, but the taxpayers in both cases relied on the economic analysis of the

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72 See S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Kluwer Law International 2022), 446-448.

73 Opinion of Advocate General Kokott, Case C-68/15, X [2017] ECLI:EU:C:2016:886, para 41.

74 Case C-284/06, Finanzamt Hamburg-Am Tierpark vs. Burda GmbH [2008] ECLI:EU:C:2008:365, para 63.

75 Opinion of Advocate General Mengozzi, Case C-284/06, Finanzamt Hamburg-Am Tierpark vs. Burda GmbH [2008] ECLI:EU:C:2008:60, para 59.

76 Compare C. Brokelind, 'Ten years of application of the Parent-Subsidiary Directive' (2003) EC Tax Review, 163. The CJEU stressed this point in its Athinaïki judgment in paragraph 29.

77 Compare R. Brandsma, S. Pancham and D. Smit, *Cursus Belastingrecht. Europees Belastingrecht* (Wolters Kluwer 2024), 8.1.13.

78 F. Van Nus and C. Philibert, 'Has the French 3% Contribution Become Compatible with EU Law and Tax Treaties?' (2013) EC Tax Review, 218.

79 Case C-294/99 Athinaïki Zithopiia AE [2001] ECLI:EU:C:2001:505, para 28, para 29.

80 Case C-68/15 X [2017] ECLI:EU:C:2017:379 and Case C-365/16 AFEP and Others [2017] ECLI:EU:C:2017:378.

81 More details about these taxes can be found in B. Michel and P. Van Den Berghe, 'Fairly Odd: Belgium's New Fairness Tax' (2014) European Taxation, 223-234 and F. Van Nus and C. Philibert, 'Has the French 3% Contribution Become Compatible with EU Law and Tax Treaties?' (2013) EC Tax Review, 213-221.

Athinaïki judgment to conclude that the tax is effectively borne by the holder of the shares. The CJEU firmly rejected this argument in the Belgium case with a simple reference to its judgment in the *Burda* case.[82] It reiterated the three criteria of its definition of a withholding tax and decided that the taxable person of the fairness tax is not the holder of the shares.[83] The fact that the chargeable event of the tax is the payment of dividends and that the taxable amount is calculated on the basis of the distributed amount is therefore not sufficient to qualify the fairness tax as a withholding tax.[84] Nevertheless, as explained in Chapter 5, the CJEU considered both taxes to be contrary to Article 4(1)(a) of the PSD.[85]

(c) Analysis of case law

The overview of the case law of the CJEU about the interpretation of "withholding tax" gives rise to some reflections. **7.030**

First of all, it is clear that the CJEU interprets the term in an autonomous – European – manner. Ever since the judgment in the *Athinaïki* case, the CJEU has made it very explicit that "it is settled case-law that the nature of a tax, duty or charge must be determined by the Court, under Community law, according to the objective characteristics by which it is levied, irrespective of its classification under national law".[86] This choice for an autonomous interpretation is consistent with the approach of the CJEU to define other legal terms of the PSD.[87] We argue that such an autonomous interpretation should be applauded, since it results in a uniform application of the PSD within the various national tax systems. **7.031**

The described body of case law illustrates how the CJEU did indeed elaborate objective characteristics to define the term "withholding tax" for the purposes of Article 5. It is constantly relying on a three-pronged definition attaching relevance to the chargeable event, the taxable amount, and the taxable person.[88] We take the view that it is actually a workable definition that does **7.032**

82 Case C-68/15 X [2017] ECLI:EU:C:2017:379, para 66.

83 Case C-68/15 X [2017] ECLI:EU:C:2017:379, para 63 and paras 65-67.

84 Case C-68/15 X [2017] ECLI:EU:C:2017:379, para 64.

85 The CJEU did not deal with the question of Article 5 in the French case, since it could settle the case on the basis of Article 4(1)(a) only.

86 Case C-294/99 Athinaïki Zithopiia AE [2001] ECLI:EU:C:2001:505, para 28, para 27. This wording has become a consistent element of the case law of the CJEU about the interpretation of "withholding tax". See, for example, Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495, para 46.

87 See also Chapter 5, Section B.3.b.i.

88 See W. Haslehner, 'Article 10: Dividends', 169 in E. Reimer and A. Rust (eds.), *Klaus Vogel on Double Taxation Conventions* (Wolters Kluwer 2021).

define the term in a sufficiently precise way. In this regard, it is very important that the CJEU clarified its view on the taxable person in the *Burda* case. The economic approach of the *Athinaïki* case would not have culminated in an appropriate separation of "corporate income tax" and "withholding tax" so that there would be a lingering legal uncertainty about the scope of Article 5. The *Burda* decision provided the necessary clarity that is also based on a sound rationale. Advocate-General Kokott put this rationale plainly into words in her opinion on the case about the Belgian fairness tax:

7.033 "42. In other words, the first taxation of the income of a subsidiary is not covered by the Parent-Subsidiary Directive. The prohibition contained in Article 5 of levying a withholding tax on the distribution of profits to a parent company accordingly does not extend to the payment of tax on income that the subsidiary generated through its economic activities, even if that tax is payable only when the subsidiary distributes profits. This finds confirmation in Article 7(1) of the directive, which specifies that advance payment or prepayment of corporation tax by a subsidiary is expressly not covered by the concept of withholding tax".[89]

7.034 The conclusion is therefore that there is a plain definition of the term "withholding tax" for the purposes of Article 5. The CJEU's material stance towards the subject-matter will probably not completely exclude future discussions and case law about this topic, but it does minimise the likelihood of substantial challenges and surprises.

C. ARTICLE 6 PSD

7.035 Article 6 stipulates that "(t)he Member State of a parent company may not charge withholding tax on the profits which such a company receives from a subsidiary". This provision is therefore basically the mirror image of Article 5, which is directed at the Member State of the subsidiary. The prohibition for the Member State of the parent company to impose a withholding tax was already included in the 1969 draft of the PSD.[90] Article 6 seems to have limited practical relevance.[91]

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89 Opinion of Advocate General Kokott, Case C-68/15, X [2017] ECLI:EU:C:2016:886, para 42. The footnotes are omitted.

90 Proposal for a Council directive on the common system of taxation applicable to parent companies and their subsidiaries of different Member States, COM(1969) 6, O.J. 1969, C39/7.

91 It may, however, have a bearing on the Belgian withholding tax system. In particular, Belgium is not permitted to apply its 'précompte mobilier' (roerende voorheffing) in cases where the relevant dividend

The interpretation of Article 6 was dealt with in the *FII GLO* case.[92] This case concerned the UK advance corporation tax (ACT) which was due by a UK parent company in case it redistributed dividends which it had received from non-UK subsidiaries. The taxpayers claimed that the ACT constitutes a "withholding tax" within the scope of Article 6. The CJEU ruled that the term "withholding tax" in Article 6 should be interpreted along the lines of the interpretation of the term for the purposes of Article 5.[93] It decided that the ACT does not constitute a "withholding tax", since the chargeable event is not the payment of dividends.[94] After all, the tax was imposed in case the parent company redistributed the dividends to its own shareholders. Consequently, Article 6 would not ban the UK from imposing this tax. This outcome is actually very much understandable when Article 7 is taken into consideration. We therefore refer to that section for further elaboration on the compatibility of the ACT system with the PSD. **7.036**

D. ARTICLE 7 PSD

Article 7 basically attempts to ensure that the PSD shall not interfere with the application of imputation systems.[95] Such systems establish a partial integration between the corporate income tax and the personal income tax through a "correction" (i.e., the granting of a tax credit) at the level of the shareholder. This mechanism works reasonably well in a completely domestic setting, but it is utterly complex – and discriminatory[96] – in a cross-border context.[97] Article 7 is therefore mostly a remainder of the 1980s and 1990's when such imputation systems were still in vogue. Member States such as the United Kingdom, France, Italy and Ireland were relying on this mechanism for the avoidance of economic double taxation in that period. It seems that at the moment only Malta still makes use of an imputation system.[98] Nevertheless, it is important to look in some more detail at this provision. **7.037**

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falls within the scope of the PSD. This Belgian tax is – under specific conditions – due by the recipient of the income (Article 262 of the Belgian Income Tax Code). That is, for instance, the case if a withholding tax exemption was unlawfully applied on the basis of an incorrect statement (e.g., in the case of fraud). The relevance of these cases, however, appears limited in the context of cases governed by the PSD.

92 Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774.

93 Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECLI:EU:C:2006:774, para 109.

94 I.e. the first criterion in the definition of the CJEU. See section B.3.

95 See S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Kluwer Law International 2022), 449.

96 Compare Case C-319/02 Manninen [2004] ECLI:EU:C:2004:484.

97 Compare, for example, P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 251.

98 S. Cnossen, 'Corporation taxes in the European Union: Slowly moving toward comprehensive business income taxation?' (2018) International Tax and Public Finance, 820.

1. Article 7(1)

7.038 Article 7(1) establishes that an advance payment, or prepayment (like the French précompte), of corporate income tax by the taxpayer to the Member State of the subsidiary does not constitute a withholding tax within the meaning of Article 5. The fact that the subsidiary makes such an advance payment in connection with a distribution of profits to its parent company is irrelevant for this matter. This provision therefore has the effect that these kinds of advance payments or prepayments are classified as corporate income tax and not as a withholding tax that would be covered by Article 5. As such, it is a crucial provision for the sake of imputation systems, since such mechanisms basically have the effect that corporate income tax serves as a withholding tax for the shareholders.[99]

7.039 The text of Article 7(1) is actually not very clear. Specific reference is made to an advance payment or prepayment (précompte) of corporation tax. As such, the text was written with the former UK, Irish, and French systems in mind.[100] The UK, Ireland, and France all imposed a so-called imputation tax to ensure that distributed profits were actually subjected to corporate income tax once a tax credit was granted.[101] The ambiguity of the text of Article 7(1) is that it does not specifically mention the comparable imputation taxes that Italy ("maggiorazione di conguaglio") and Germany ("Ausschüttungsbelastung") used to rely on. This lack of clarity has, however, not resulted in case law about the interpretation of the terms "advance payment" or "prepayment". One may wonder, though, why the Member States did not decide to include more specific derogations for Member States with imputation systems back then. Such a system of derogations worked reasonably well for the specific tax systems of Greece, Germany, and Portugal.[102] It cannot be excluded that such a specific derogation would be unacceptable for the UK.

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99 After all, the shareholder obtains a tax credit against (personal or corporate) income tax to the extent that this corporate income tax can be attributed to the relevant dividend.

100 The *Schneider* case gives some insight into the legislative history of Article 7. The French government argued that the UK took the initiative for this derogation and that France was happy to compromise on this matter. See Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2022:378, para 68 and Opinion of Advocate General Kokott, Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2021:857, para 71.

101 Such an imputation tax was mostly relevant in case the company was distributing foreign income. An imputation tax has similarities with an equalisation tax which was discussed in the context of Article 5. Imputation taxes are, however, a characteristic of imputation systems, whereas the discussed equalisation taxes were an element of split-rate systems.

102 See section B.1.

2. Article 7(2)

7.040 Another characteristic of imputation systems was that they usually did not provide for the granting of a tax credit to a foreign shareholder. Some Member States did, however, grant some relief from economic double taxation to such shareholders through unilateral measures or a double tax treaty.[103] Both the UK and Italy did, for example, grant an imputation credit to foreign parent companies in their respective tax treaties with the Netherlands. This manner was the subject of the *Océ van der Grinten* case and the *Ferrero and General Beverage* cases, which were already discussed in the context of Article 5.

7.041 Article 7(2) is also of relevance for this subject matter. Basically, a textual analysis of this second paragraph of Article 7 suggests that the provision ensures that the Directive does not interfere with such provisions in double tax treaties. This provision makes, after all clear that "(t)his Directive shall not affect the application of domestic or agreement-based provisions designed to eliminate or lessen economic double taxation of dividends". Subsequently, Article 7(2) is even more specific when it explicates that this includes "in particular provisions relating to the payment of tax credits to the recipients of dividends". As such, the text basically suggests that Article 7(2) establishes a broad carve-out for relevant provisions of national tax law and double tax treaties within the framework of imputation systems.[104]

7.042 Such a straightforward interpretation of Article 7(2) however somewhat underestimates the complexity of imputation systems. The earlier discussion of the *Océ van der Grinten* case and the *Ferrero and General Beverage* cases – in the context of Article 5 – already made clear that a withholding tax was due on the tax credit as such (in the UK) or on the refunding of the Italian imputation tax. Consequently, the CJEU had to assess the compatibility of such additional taxes with Article 7(2). After all, as the taxpayer stressed in the *Océ van der Grinten* case, a tax like the UK withholding tax[105] "is not a measure designed to eliminate or lessen economic double taxation of dividends".[106] Consequently, the question was raised whether the interpretation of Article

103 An overview can be found in P. Farmer and R. Lyal, *EC Tax Law* (Clarendon Press 1994), 252.

104 In the Athinaïki case, the CJEU unambiguously dismissed the claim of the Greek government that the disputed tax can be justified by Article 7(2). It held that the dividend article of the relevant double tax treaty does not provide for the avoidance of economic taxation, so it is out of the scope of Article 7(2). See Case C-294/99 Athinaïki Zithopiia AE [2001] ECLI:EU:C:2001:505, para 28, paras 30-32.

105 As discussed before, the UK withholding tax constituted a (combined) 5% tax on the dividend distribution and a 5% tax on the tax credit. This combined withholding tax, to which the taxpayer is referring, was known as "abatement".

106 Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495, para 64.

7(2) should be dependent on the objective of the PSD as a whole and the provision in particular.

7.043 The CJEU decided in both the UK and the Italian cases that Article 7(2) should be interpreted as an exception to Article 5.[107] In other words, Article 7(2) is only relevant to the extent that a tax is supposed to be a "withholding tax" within the meaning of Article 5. This ascertainment implied that the exception of Article 7(2) was relevant for the UK to the extent that the "abatement" was qualified as such a withholding tax.[108] The situation in Italy was even more complex, since the CJEU left it to the referring court to interpret the refund of the Italian imputation tax on the basis of the Court's criteria for a "withholding tax".

7.044 Subsequently, the CJEU made clear in both judgments that the exception of Article 7(2) should be interpreted in a strict manner.[109] Consequently, a Member State, like the UK or Italy, could not simply justify the imposition of these kinds of "withholding taxes" for the mere reason that it had agreed upon such a tax with its treaty partners. The CJEU ruled in the Italian cases, with a reference to its judgment in the *Océ van der Grinten* case,[110] that such taxes are only within the scope of Article 7(2) to the extent that "first, the bilateral convention contained provisions intended to eliminate or mitigate the economic double taxation of dividends and, secondly, the charging of that withholding tax was not such as to cancel out the effects thereof".[111]

7.045 This limitation of a double tax treaty on the basis of EU law did, however, not affect the UK withholding tax. The UK actually got away with the final assessment of the CJEU that the (disputed) withholding tax on dividends was

107 Actually, the CJEU was very explicit about this in the joined cases *Ferrero and General Beverage* (see Joined Cases C-338/08 and 338/09, P. Ferrero e C. SpA vs. Agenzia delle Entrate – Ufficio di Alba and General Beverage Europe BV vs. Agenzia delle Entrate – Ufficio di Torino 1, [2010] ECLI:EU:C:2010:364, paras 43-44). It was a bit more implicit on this matter in its judgment in the *Océ van der Grinten* case.

108 Article 7(2) would therefore only be of relevance for the 5% tax on the dividend distribution and not for the tax on the tax credit. See the earlier discussion of this case in section 2.c.1.

109 Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495, para 86 and Joined Cases C-338/08 and 338/09, P. Ferrero e C. SpA vs. Agenzia delle Entrate – Ufficio di Alba and General Beverage Europe BV vs. Agenzia delle Entrate – Ufficio di Torino 1, [2010] ECLI:EU:C:2010:364, para 45.

110 Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495, para 87.

111 Joined Cases C-338/08 and 338/09, P. Ferrero e C. SpA vs. Agenzia delle Entrate – Ufficio di Alba and General Beverage Europe BV vs. Agenzia delle Entrate – Ufficio di Torino 1, [2010] ECLI:EU:C:2010:364, para 46. Effectively, the CJEU is following Advocate-General Alber's interpretation of this provision as proposed in his conclusion in the Athinaïki case. The CJEU did not take a stance on this matter in the Athinaïki case. See Opinion of Advocate General Alber, Case C-294/99 Athinaïki Zithopiia AE [2001] ECLI:EU:C:2001:263, para 41.

within the scope of Article 7(2).[112] This "agreeable" interpretation was certainly not in line with expectations.[113] As a matter of fact, the CJEU clearly erred when it ruled that the UK tax would be deductible from the tax due in the Netherlands, since it misjudged the application of the participation exemption in the Netherlands.[114]

The merit of the Court's interpretation is therefore that the object and purpose of the provision play a decisive role. A Member State can only rely upon Article 7(2) when the taxation at issue does not mitigate the advantageous treatment for the taxpayer (i.e., the elimination or mitigation of economic double taxation of dividends) as a result of the application of national tax law or the double tax treaty. This interpretation can also be derived from the CJEU's judgment in the *Schneider* case about the interpretation of Article 7(2) in the light of Article 4 of the Directive.[115] In this judgment, the CJEU decided convincingly that the wording of Article 7(2) makes explicitly clear that the scope of application of this provision is – unlike Article 7(1) – not limited to withholding taxes as meant in Articles 5 and 6.[116] Subsequently, the CJEU aligned with the already discussed case law to rule that Article 7(2) has the objective of respecting provisions of national tax law or a double tax treaty – aiming at the avoidance of double taxation – to the extent that these provisions are in accordance with the spirit of the directive.[117] It decided that the French combined system of advance payments (i.e. the précompte mobilier) and tax credits – which is contrary to Article 4 – does not meet this objective in the particular case at hand.[118] Article 7(2) therefore does not safeguard the application of Article 4 in this particular French case. **7.046**

All in all, it should be concluded that the CJEU's teleological approach ensures an appropriate interpretation of Article 7(2) in its role as an exception to Articles 4 and 5. Indeed, it cannot be the case that Article 7(2) serves as a general justification for any tax that is levied in relation to a provision of national tax law or a double tax treaty that is aimed at the elimination or mitigation of economic double taxation of dividends. The only remaining **7.047**

112 Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495, paras 87-88.

113 Compare F. De Hosson, 'The Parent-Subsidiary Directive' (1990) Intertax, 435.

114 Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:495, paras 87-88.

115 Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2022:378.

116 Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2022:378, para 67.

117 Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2022:378, para 76. Also compare paragraph 85.

118 A detailed analysis of this case can be found in T. Kollruss, 'Transnational Grouping of Companies and Unresolved Questions Regarding the EU Parent-Subsidiary Directive: Implications for Companies, Member States and Non-EU Member States' (2022) European Taxation, 537-543.

uncertainty is how the CJEU actually carries out its "neutralisation test". As explained before, it is not very clear why the UK was salvaged in the *Océ van der Grinten* case.[119] On the other hand, the CJEU was basically performing a calculation in the *Schneider* case to test whether the charging of a withholding tax is actually counterbalancing the favourable treatment that is provided for in national tax law or the double tax treaty.[120] It seems therefore that it is not sufficient to evaluate whether "derogations (. . .) 'merely' not compromise the spirit and purpose of the Parent-Subsidiary Directive", as Advocate-General Kokott wrote in that case.[121] A further explanation of this matter would, however, elucidate the interpretation of Article 7(2). Perhaps the CJEU's case law on the "neutralisation" of discriminatory taxes as a result of a tax credit – in the context of the fundamental freedoms – may serve as a source of inspiration in this regard.[122]

E. RECOMMENDATIONS FOR THE FUTURE

7.048 The straightforward conclusion of this chapter is that there is hardly any lingering uncertainty about the interpretation of Articles 5, 6, and 7 of the PSD. These provisions have become a stable element of the tax systems of the Member States. The question does arise, though, whether these provisions will have a long-lasting future in their current form. One may wonder, for example, whether it is worthwhile to maintain a specific provision for imputation systems when such systems are actually out of fashion. A specific derogation for Malta would probably be sufficient in the future.

7.049 The more general question is whether the broad scope of the prohibition to impose a withholding tax of Article 5 should be reconsidered. Indeed, the case law on the application of the anti-avoidance provision in relation to Article 5 illustrates that the exemption gives rise to directive shopping. It is therefore a valid question whether the current scope of Article 5 has not somewhat lost touch with its original objective. That earliest intent concerned the mitigation of economic double taxation in order to facilitate the creation of pan-European

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119 A critical analysis of the Océ van der Grinten case can be found in the European team of the IBFD, 'The Océ van der Grinten Case: Implications for Other EU Member States. A Critical Assessment' (2003) European Taxation, issue 11, 394-402.

120 Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2022:378, para 82 in conjunction with para 53.

121 See Opinion of Advocate General Kokott, Case C-556/20 Schneider Electric [2022] ECLI:EU:C:2021:857, para 69. The CJEU did not follow its A-G in the judgment in the *Schneider* case, so it might be the case that it did indeed not accept such a more imprecise methodology to perform the "neutralisation test".

122 See S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Kluwer Law International 2022), 168-172.

groups on the internal market.[123] Shouldn't we observe this objective more closely in order to make the application of Article 5 less vulnerable to Directive shopping?[124]

It might, for example, be considered to add a standard about the annual combined revenues of the group as a whole to the criteria for the application of Article 5. It goes without saying that this new standard could be different from the amount of EUR 750 million that is increasingly becoming the relevant norm for such revenues.[125] We should, however, reflect on such a restriction of the scope of Article 5 when the PSD is revised in the future. It is very well possible that a present-day balancing of the needs of the internal market, on the one hand, and the interests of the Member States to preserve their tax revenues, on the other hand, is somewhat different from 35 years ago.[126] **7.050**

123 See section B.1. Advocate-General Tizzano made this objective perfectly clear in his opinion in the *Océ van der Grinten* case. He wrote: "The purpose of that provision (i.e. Article 5; CP), as I pointed out above, is the elimination or lessening of economic double taxation of profits distributed by a subsidiary company to a parent company, insofar as it adversely affects the establishment of groups of cross-border companies within the Community". See Opinion of Advocate General Tizzano, Case C-58/01 Océ van der Grinten NV [2003] ECLI:EU:C:2003:48, para 29.

124 More generally, it would be worthwhile to take this aspect into account this aspect for the purposes of the interpretation of the anti-abuse provision. Pending case law in the Netherlands about the application of Article 5 in the context of investment vehicles of wealthy families is illustrating that the current interpretation of Articles 1(2)-1(4) is struggling to come to terms with the goal of creating pan-European groups on the internal market. An overview of this case law can be found in M. Verhoog and J.M. Leijen, 'Inhoudingsvrijstelling dividendbelasting: de (nieuwe?) tussenstand van de jurisprudentie en toepassing op grensoverschrijdende investeringsfondsen' (2024) Weekblad Fiscaal Recht, 48.

125 See, for example, Article 2 of the BEFIT proposal: Proposal for a Council Directive on Business in Europe: Framework for Income Taxation (BEFIT), COM(2023) 532.

126 Advocate-General Alber wrote about this balancing in his opinion in the *Bosal* case. He wrote: "The provisions of the directive can therefore be regarded as the outcome of the Community legislature's careful consideration of the Member States' interests in maintaining their tax revenue on the one hand against common market and internal market concerns on the other". See Opinion of Advocate General Alber, Case C-168/01, Bosal [2003] ECLI:EU:C:2002:528, para 55.

8

ARTICLE 8: IMPLEMENTATION

Filip Debelva

Member States shall bring into force the laws, regulations, and administrative provisions necessary to comply with this Directive as from 18 January 2012. They shall forthwith inform the Commission thereof.

When Member States adopt these measures, they shall contain a reference to this Directive or shall be accompanied by such reference on the occasion of their official publication. The methods of making such reference shall be laid down by Member States.

Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive together with a correlation table between them and this Directive.

COMMENTARY

8.001 Article 8 governs the implementation of the Directive and, consequently, its temporal scope of application. The implementation date of the Directive was on 18 January 2012. Given that the present version of the Directive is a recast, Member States were duly aware of their obligations already with respect to the original Directive and its amendments.[1] Hence, several Member States did not consider transposition to be necessary.

The legal consequences of the direct effect of the Directive are discussed in Article 7 IRD. The direct effect of Articles 4(1) – despite the choice left to Member States in implementing that provision)[2] – and 5[3] PSD have already been confirmed by the CJEU.[4] **8.002**

1 For a discussion on implementation issues in relation to the original directive, see N. Raby, 'National Implementation of the Parent-Subsidiary Directive: Some Problems and Opportunities Identified', (1992) *EC Tax Review*, issue 4, 216-223.

2 Case C-138/07 Cobelfret [2009] ECLI:EU:C:2009:82, paras 58-65.

3 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387, paras 37-40.

4 The author assumes that the same conclusion could be upheld for Article 6 PSD.

9

ARTICLE 9: REPEAL OF DIRECTIVE 90/435/EEC

Filip Debelva

Directive 90/435/EEC, as amended by the acts listed in Annex II, Part A, is repealed, without prejudice to the obligations of the Member States relating to the time limits for transposition into national law of the Directives set out in Annex II, Part B.

References to the repealed Directive shall be construed as references to this Directive and shall be read in accordance with the correlation table in Annex III.

COMMENTARY

9.001 The provision confirms that the original Parent-Subsidiary Directive has been formally repealed by the adoption of the present directive. The repeal applies *without prejudice* to the obligations imposed on Member States with respect to the transposition deadlines set out in the earlier amending acts. More specifically, Member States remain bound by the original and amended transposition deadlines of the three relevant directives: Directive 90/435/EEC (by 31 December 1991), Directive 2003/123/EC (by 1 January 2005), and Directive 2006/98/EC (by 1 January 2006). This provision ensures continuity in the implementation timelines insofar as necessary and avoids any disruption to Member States' legal obligations.

9.002 In addition, the provision clarifies that references to the repealed directive shall now be interpreted as references to the present directive, in accordance with the correlation table provided in Annex III. This is a standard provision that facilitates legal continuity and ensures a smooth transition from the old to the new legal framework, particularly for ongoing proceedings or references made under the former directive. Below a copy can be found of the correlation table as included in Annex III.

Table 9.1 Correlation Table

Directive 90/435/EEC	**This Directive**
Article 1(1) first to fourth indents	Article 1(1)(a) to (d)
Article 1(2)	Article 1(2)
Article 2(1) first part of the introductory phrase	Article 2 introductory phrase
Article 2(1) second part of the introductory phrase	Article 2(a), introductory phrase
Article 2(1)(a)	Article 2(a)(i)
Article 2(1)(b)	Article 2(a)(ii)
Article 2(1)(c) introductory phrase of the first subparagraph and second subparagraph	Article 2(a)(iii)
Article 2(1)(c), first subparagraph, first to twenty-seventh indents	Annex I, Part B, first to twenty-seventh indents
Article 2(2)	Article 2(b)
Article 3(1) introductory phrase	Article 3(1), introductory phrase
Article 3(1)(a) first subparagraph, initial words	Article 3(1)(a), introductory phrase
Article 3(1)(a) first subparagraph, final words	Article 3(1)(a)(i)
Article 3(1)(a) second subparagraph	Article 3(1)(a)(ii)
Article 3(1)(a) third subparagraph	–
Article 3(1)(a) fourth subparagraph	–
Article 3(1)(b)	Article 3(1)(b)
Article 3(2) first and second indents	Article 3(2)(a) and (b)
Article 4(1) first and second indents	Article 4(1)(a) and (b)
Article 4(1a)	Article 4(2)
Article 4(2) first sentence	Article 4(3) first subparagraph
Article 4(2) second sentence	Article 4(3) second subparagraph
Article 4(3) first subparagraph	Article 4(4)
Article 4(3) second subparagraph	Article 4(5)
Articles 5, 6 and 7	Articles 5, 6 and 7
Article 8(1)	–
Article 8(2)	Article 8
–	Article 9
–	Article 10
Article 9	Article 11
Annex	Annex I, Part A
–	Annex II
–	Annex III

10

ARTICLE 10: ENTRY INTO FORCE

Filip Debelva

This Directive shall enter into force on the 20th day following its publication in the *Official Journal of the European Union*.

COMMENTARY

In accordance with Article 297 TFEU, Article 10 specifies the date on which the Directive entered into force. It states that the Directive entered into force on the 20th day following its publication in the Official Journal, which was 29 December 2011. **10.001**

11

ARTICLE 11: ADDRESSEES

Filip Debelva

This Directive is addressed to the Member States.

COMMENTARY

11.001 Article 11 of the Directive requires little commentary. It states that the Directive is addressed to the Member States of the EU. In line with the general rules of EU law, it is binding, as to the result to be achieved, upon each of them.[1]

11.002 Although it goes beyond the scope of the present book, it may be interesting to refer in this context to the agreement between the European Union and Switzerland providing for a number of measures equivalent to those laid down in the Directive.[2]

1 Article 288 TFEU: 'A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods'.

2 Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, O.J. 2004 L 385/30. For a discussion, see e.g. K. Eicker and R. Obser, 'The impact of the Swiss-EC Agreement on intra-group dividend, interest and royalty payments' (2006) EC Tax Review, issue 3, 134.

12

THE INTEREST AND ROYALTY DIRECTIVE: INTRODUCTION AND PREAMBLE

Niels Bammens and Filip Debelva

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 94 thereof,

Having regard to the proposal from the Commission,[1]

Having regard to the opinion of the European Parliament,[2]

Having regard to the opinion of the European Economic and Social Committee,[3]

Whereas:

(1) **In a Single Market having the characteristics of a domestic market, transactions between companies of different Member States should not be subject to less favourable tax conditions than those applicable to the same transactions carried out between companies of the same Member State.**

(2) **This requirement is not currently met as regards interest and royalty payments; national tax laws coupled, where applicable, with bilateral or multilateral agreements may not always ensure that double taxation is eliminated, and their application often entails burdensome administrative formalities and cash-flow problems for the companies concerned.**

(3) **It is necessary to ensure that interest and royalty payments are subject to tax once in a Member State.**

(4) **The abolition of taxation on interest and royalty payments in the Member State where they arise, whether collected by deduction at source or by**

1 OJ C 123, 22 April 1998, 9.

2 OJ C 313, 12 Oct. 1998, 151.

3 OJ C 284, 14 Sept. 1998, 50.

assessment, is the most appropriate means of eliminating the aforementioned formalities and problems and of ensuring the equality of tax treatment as between national and cross-border transactions; it is particularly necessary to abolish such taxes in respect of such payments made between associated companies of different Member States as well as between permanent establishments of such companies.

(5) **The arrangements should only apply to the amount, if any, of interest or royalty payments which would have been agreed by the payer and the beneficial owner in the absence of a special relationship.**

(6) **It is moreover necessary not to preclude Member States from taking appropriate measures to combat fraud or abuse.**

(7) **Greece and Portugal should, for budgetary reasons, be allowed a transitional period in order that they can gradually decrease the taxes, whether collected by deduction at source or by assessment, on interest and royalty payments, until they are able to apply the provisions of Article 1.**

(8) **Spain, which has launched a plan for boosting the Spanish technological potential, for budgetary reasons should be allowed during a transitional period not to apply the provisions of Article 1 on royalty payments.**

(9) **It is necessary for the Commission to report to the Council on the operation of the Directive three years after the date by which it must be transposed, in particular with a view to extending its coverage to other companies or undertakings and reviewing the scope of the definition of interest and royalties in pursuance of the necessary convergence of the provisions dealing with interest and royalties in national legislation and in bilateral or multilateral double-taxation treaties.**

(10) **Since the objective of the proposed action, namely setting up a common system of taxation applicable to interest and royalty payments of associated companies of different Member States cannot be sufficiently achieved by the Member States and can therefore be better achieved at Community level, the Community may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective,**

HAS ADOPTED THIS DIRECTIVE:

COMMENTARY

A. HISTORICAL BACKGROUND

When 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 (hereafter "the Interest & Royalty Directive" or "the Directive") was adopted in 2003,[4] it was the culmination of an arduous legislative process that spanned more than a decade. 12.001

The first draft directive was published in 1991 as a Proposal for a Council directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States[5] (hereafter: "the 1991 Proposal"). In its preamble, that proposal considered it necessary for the development of a common market that transactions between companies in different Member States were not treated less favourably than transactions between companies in the same Member State. That requirement was not met as regards interest and royalty payments, because there was no mechanism to completely eliminate double taxation and because the application of the relevant domestic and treaty rules gave rise to administrative formalities and cash position problems. According to the preamble, the "abolition of all withholding taxes on interest and royalty payments is the most appropriate means of eliminating such formalities and problems and of ensuring equality of tax treatment as between national and transnational transactions".[6] 12.002

The 1991 Proposal already included some of the main features of the Directive that would ultimately be adopted in 2003, including the basic mechanism of requiring the source state to refrain from taxing qualifying payments and the 25% participation requirement. As regards that latter element, the preamble to the 1991 Proposal suggested that, ultimately, *all* withholding taxes on interest and royalty payments between companies should be abolished.[7] This intention 12.003

4 OJ L 157, 26 June 2003, 49–54.
5 COM(90) 571 final, OJ C 53, 28 February 1991, 26.
6 Recitals 2 and 4 of the preamble to the Directive.
7 See also Opinion of the Economic and Social Committee on the Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, OJ C 120, 6 May 1991, 15: "the abolition of withholding taxes on interest and royalties payments between parent companies and subsidiaries established in different

is also implicit in Article 8 of the Directive, which required the Commission to report to the Council on the operation of the Directive, "in particular with a view to extending its coverage to companies or undertakings other than those referred to in Article 3 and the Annex".[8] Initially, however, the most urgent matter was the issue of double taxation on interest and royalty payments between parent companies and subsidiaries, which explains the inclusion of the participation requirement.[9] It appears that that restricted scope was considered necessary to alleviate the budgetary impact of the proposal, particularly for Member States that were net importers of capital and technology.[10]

12.004 The Economic and Social Committee, however, took the position that the 25% threshold was too high. It argued that the Parent-Subsidiary Directive, which initially also used a 25% participation threshold (see Chapter 4), had a fundamentally different objective, so that it was not appropriate to take the same approach in the Interest & Royalty Directive. The Economic and Social Committee pointed out that the Parent-Subsidiary Directive intended to avoid double taxation of intra-group profit distributions, with the ultimate objective of facilitating the creation of groups of companies located in different Member States. Against that backdrop, it was reasonable to use a 25% threshold as a requirement for the group "to be deemed a single economic entity exempt from

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Member States is only a first step. All interest and royalty payments within the Community should be exempt from withholding taxes, irrespective of any connection between the companies concerned".

8 In that report, the Commission confirmed that the initial limitation to associated companies is "an experimental first step" as the same obstacles are also present in the case of payments between unrelated parties (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, COM(2009)179, 9).

9 See recital 3 of the preamble to the 1991 Proposal: "Whereas abolition of all withholding taxes on interest and royalty payments is the most appropriate means of eliminating such formalities and problems and of ensuring equality of tax treatment as between national and transnational transactions; whereas it is necessary, initially, to abolish withholding tax in respect of such payments of special importance made between parent companies and subsidiaries".

10 See para. 14-15 of the Explanatory Memorandum to the 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), 4 March 1998: "In order to alleviate the budgetary impact of the interest and royalties proposal, particularly for those Member States which are net importers of capital and technology and for which these taxes on such payments represent an appreciable source of revenue, a gradual approach as far as the scope of the Directive is concerned would seem to be appropriate. Initially, therefore, it is only proposed that the taxes collected at source or by assessment on interest and royalty payments made between associated companies [. . .] should be abolished, as such taxes fall most frequently on transactions between associated companies. It will be possible to extend the measure later, as part of the further development of the Single Market, to taxes of this type levied on interest and royalty payments made between companies which are not associated."

double taxation of profits ploughed back into investment within the group".[11] By contrast, the intention of the Interest & Royalty Directive was quite different, as it only represented "the first step in comprehensive arrangements for the complete exemption of financial flows within the Community". The Economic and Social Committee therefore considered that, "since a 10% holding is sufficient in most Member States, it should be possible to use the same figure for the Directive".[12]

Interestingly, the participation threshold under the Parent-Subsidiary Directive has since been lowered to 10% (see Chapter 4), while it is still 25% under the Interest & Royalty Directive (see Chapter 15). Similarly, the participation threshold under Article 7 of the Merger Directive is also set at 10%.[13] Moreover, the scope of the Interest & Royalty Directive is limited to direct holdings, whereas the Parent-Subsidiary Directive also applies to indirect holdings (see Chapter 4). **12.005**

In 2009, the Commission recognised that the different threshold under the Interest & Royalty Directive, as compared to the other two directives, was problematic as it is liable to increase the planning and compliance costs of companies involved in cross-border operations and to produce incongruous results (for instance, if an interest payment between companies associated through a holding of at least 10% but less than 25% does not qualify for relief under the Interest & Royalty Directive, while it would qualify for relief under the Parent-Subsidiary Directive if it were reclassified as a profit distribution). In addition, the Commission considered that there was "no obvious justification" for the exclusion of indirect holdings from the scope of the Interest & Royalty Directive.[14] **12.006**

In 1992, the Ruding Report considered that the elimination of withholding taxes on interest and royalty payments was of vital importance for the functioning of the internal market and therefore urged the speedy adoption of the **12.007**

11 Opinion of the Economic and Social Committee on the Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, OJ C 120, 6 May 1991, 16.

12 Ibid.

13 Article 7 of Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States.

14 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, COM(2009)179, 9.

1991 Proposal (while also recommending that the scope of the Directive be extended).[15] In 1993, the 1991 Proposal was amended to clarify the definitions of "interest" and "royalties".[16] A year later, however, things fell apart. Because it was impossible to find unanimity in the Council on a variety of issues, the Commission decided to withdraw the proposal at the end of 1994.[17]

12.008 Some four years later, the proposal was revived when the Commission published a new proposal in 1998 (the 1998 Proposal).[18] That proposal would form the basis for the Directive that was ultimately adopted in 2003. Interestingly, the 1998 Proposal formed part of a wider "tax package" consisting of three measures to tackle harmful tax competition: the proposed Interest & Royalty Directive, a proposal for a directive on the taxation of savings income (which would later become the Savings Directive), and the Code of Conduct on Business Taxation. According to the Commission, combining the different proposals in a package offered a better prospect of agreement than would be possible if each issue were tackled separately.[19] Presumably, the underlying idea was that the Interest & Royalty Directive and Code of Conduct, with their expected benefits for Member States and companies, could act as the metaphorical spoonful of sugar to help the medicine of the Savings Directive go down (as the latter was expected to provoke more resistance).[20]

12.009 Evidently, that approach also created a risk of delays. Because the different initiatives were tied together, there was an understanding that the Interest & Royalty Directive could not be adopted before there was an agreement on the Savings Directive.[21] Because a number of Member States were steadfast in

15 EU Commission, Conclusions and recommendations of the Committee of independent experts on company taxation, 1992.

16 Amended proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, COM(1993) 196 final, OJ C 178, 30 June 1993, 18.

17 Para. 5 of the Explanatory Memorandum to the 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), 4 March 1998.

18 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, OJ C 123, 22 April 1998, 9.

19 A package to tackle harmful tax competition in the European Union, COM(97) 564 final, 5 November 1997, para. 7.

20 For a similar observation on the more recent BEFIT proposal, see J. Korving, 'BEFIT and HOT: FASTER and SAFE! EU Law or Slogan for Slimming Pills?' (2023) European Taxation, 513-514.

21 See e.g. Conclusions of the ECOFIN Council meeting on 1 December 1997 concerning taxation policy (98/C 2/01), OJ C 2, 6 January 1998, 3: "The Belgian, Italian and Portuguese delegations state that they will not agree to the Directive on interest and royalty payments between companies before the Directive on the taxation of savings is adopted".

their resistance to the latter directive, it took until 2003 for both directives to be adopted.

B. GENERAL OVERVIEW

The adoption of the Interest & Royalty Directive in 2003 represented an important step in the elimination of tax obstacles to the internal market. It is true that the issue addressed by the Directive, i.e. the potential double taxation of interest and royalty payments, was not quite as impactful as that addressed by the Parent-Subsidiary Directive (see Chapter 1). Indeed, even before the introduction of the Interest & Royalty Directive, many Member States refrained from levying withholding taxes on outbound interest and royalty payments under their domestic law, and/or agreed to a reduced rate (with respect to interest payments; see Article 11 of the OECD Model Convention) or an exemption (with respect to royalties; see Article 12 of the OECD Model Convention) in bilateral tax treaties with other Member States. Nevertheless, some important issues remained. **12.010**

In particular, withholding tax reductions or exemptions under tax treaties are generally not applied at source. Instead, the income is generally subject to withholding tax at the full domestic rate, after which the recipient can file a refund claim with the tax authorities in the source state. Obviously, such procedures may create a host of issues: they can be administratively burdensome and often take a long time to be completed; they may require the involvement of local tax advisors, etc. Even more importantly, the foreign tax credit under tax treaties is in principle not a full credit but an ordinary credit, i.e., a credit that is limited to the amount of tax that the residence state would levy on the income (see Article 23B of the OECD Model Tax Convention). As a result, double taxation remains to the extent that the foreign tax credit granted in the residence state is lower than the amount of withholding tax levied in the source state. That outcome is particularly likely since withholding taxes are often levied on a gross basis (i.e., without the deduction of any expenses incurred in earning the income) while the foreign tax credit in the residence state is generally calculated on a net basis.[22] **12.011**

For those reasons, the Directive's objective of eliminating source state taxation on interest and royalty payments between associated companies is of **12.012**

22 A. Cordewener, 'The Interest and Royalties Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 621-622.

considerable importance for the development of the internal market. The preamble to the Directive (just like the preamble to the 1991 Proposal, see above) therefore emphasises the importance of ensuring that cross-border transactions are not treated less favourably than domestic transactions, and that double taxation and administrative burdens should be removed.[23]

12.013 At the same time, however, the preamble recognises that interest and royalty payments should not escape taxation altogether by stating that it "is necessary to ensure that interest and royalty payments are subject to tax once in a Member State".[24] Despite that concern, the Directive does not contain a subject-to-tax requirement as a condition for payments to be exempt. The definition of "company of a Member State" in Article 3 of the Directive requires the company to be "subject to one of the following taxes without being exempt", but does not expressly require the interest and royalty payments as such to be subject to tax. Remarkably, the beneficial ownership requirement in Article 1(5) of the Directive does contain a subject-to-tax requirement, but only for permanent establishments (see Chapter 13), so that the issue discussed here only concerns the situation where the beneficial owner is a company.

12.014 In order to prevent situations of double non-taxation, a 2003 proposal sought to include the requirement in Article 1 of the Directive that the beneficial owner "is effectively subject to tax on the interest or royalty payments in that other Member State",[25] but that proposal was withdrawn in 2010.[26] Another attempt to include a subject-to-tax requirement was made in 2011,[27] but the proposal ultimately stalled. In later years, the issue was regularly discussed,[28] but no real progress was made. The objective of ensuring that interest and royalty payments are subject to tax (exactly) once is therefore not borne out by the text of the Directive.

23 Recitals 1-2 of the preamble to the Directive.

24 Recital 3 of the preamble to the Directive.

25 Proposal for a Council Directive amending Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, COM(2003) 841 final, 30 December 2003.

26 Withdrawal of obsolete Commission proposals, OJ C 252, 18 September 2010, 11.

27 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 (recast), 11 November 2011, COM(2011) 714 final.

28 E.g., ECOFIN Report to the European Council on tax issues, 7 December 2017, 15405/17, para. 38: "The Estonian Presidency consulted Member States on the basis of a new compromise along the following lines: [. . .] adding the 'subject to tax' requirement to Article 1 (1) and aligning the wording of the targeted anti-abuse rule with the one contained in the Parent-Subsidiary Directive (PSD) and the Anti-tax avoidance Directive 1 (ATAD 1)".

12.015 All those attempts, however, now appear to be water under the bridge. In its 2019 decision in the "Danish cases", the Court of Justice has taken up the mantle of preventing double non-taxation. In that decision, the Court has taken the position that the requirement in Article 3 that a company is "subject to one of the following taxes without being exempt" necessarily means that the interest (or royalty) is subject to tax. It found support for that position in the subject-to-tax requirement for permanent establishments in Article 1(5) of the Directive as well as in the statement in the preamble that "it is necessary to ensure that interest and royalty payments are subject to tax once in a Member State" (see above). The Court therefore held that an entity cannot be classified as a "company of a Member State" for the purposes of the Directive if the interest (or royalty) it receives is exempt in its state of residence.[29]

12.016 Of course, the Directive's objective of ensuring that interest and royalty payments are subject to tax once in a Member State begs the question *which* Member State should be entitled to levy tax. By providing for an exemption in the source state, the Directive allows for the beneficial owner's Member State of residence (or the Member State where the permanent establishment is situated) to tax the payments. It appears that the choice in favour of the residence state was intended to ensure that the income can be taxed in the same jurisdiction where the corresponding expenditures are deductible (i.e., the cost of raising capital in the case of interest income and research and development costs in the case of royalties).[30]

C. CRITICISM AND POTENTIAL AMENDMENTS

12.017 Despite its importance, the Directive has never been entirely free from criticism. As noted above, the 1991 Proposal was already criticised for a lack of ambition due to its use of a 25% participation threshold. Similarly, the 1998 Proposal has been characterised as taking "an over-wary approach", leading to a scope that is too restricted.[31] Even the basic mechanism of the Directive, i.e., the abolition of withholding taxes on interest and royalty payments, has been

29 Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16 *N Luxembourg 1 and Others v Skatteministeriet* [2019] ECLI:EU:C:2019:134, para. 150-153.

30 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, COM(2009)179, 3.

31 Opinion of the Economic and Social Committee on the 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 (98/C 284/09), OJ C 284, 14 Sept. 1998, 51.

called a "recipe for disaster" and criticised for lacking a policy rationale.[32] In addition, the potential application of an attestation requirement in the source state (see also Chapter 13) has been condemned as unreasonably burdensome.[33] Nevertheless, the Directive has not been fundamentally amended since its introduction over twenty years ago.

12.018 In 2009, the Commission published a report on the implementation and operation of the Directive (see also Chapter 15). In that report, the Commission took the position that, despite a number of cases of questionable transposition and interpretation, the overall implementation by Member States was satisfactory but that further discussion and guidance in respect of key concepts was necessary to achieve uniformity of interpretation. The report concluded by stating that "consideration might now be given to extending the scope of the Directive to unrelated undertakings, with a view to assess its potential to further the Lisbon objectives."[34]

12.019 As noted above, the Directive was always intended to be extended to payments between unrelated parties at some future date. It is indeed difficult to justify the different treatment of related and unrelated parties in light of the Directive's objective, particularly considering that transactions between unrelated parties are less likely to give rise to tax abuse.[35] The 2009 Commission report on the operation of the Directive emphasised that an extension to unrelated parties would be consonant with the objective laid down in Article 163(1) of the EC Treaty[36] and that it would make the Directive consistent with Articles 11 and 12 of the OECD Model Convention, which do not distinguish between related and unrelated party transactions. While the 2009 report acknowledged that the budgetary impact of the extension would have to be considered, it argued that that impact would likely be limited because "most MS already waive their taxing rights partly or wholly, either through domestic legislation or in their

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32 A. Easson, 'Fiscal degradation and the inter-nation allocation of tax jurisdiction' (1996) EC Tax Review, issue 3, 113.

33 S. Raventos, 'On the Interest and Royalties Directive, or How an Espresso Measure May Become a Decaf One' (2000) European Taxation, issue 7, 286.

34 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, COM(2009)179, 10.

35 A. Cordewener, 'The Interest and Royalties Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 648.

36 Currently, Article 179(1) TFEU states: "The Union shall have the objective of strengthening its scientific and technological bases by achieving a European research area in which researchers, scientific knowledge and technology circulate freely, and encouraging it to become more competitive, including in its industry, while promoting all the research activities deemed necessary by virtue of other Chapters of the Treaties."

DTCs with other MS."[37] Fifteen years on, that outlook has turned out to be too optimistic as there is no indication that the scope of the Directive will be extended in the near future.

This appears to be something of a recurring theme. There is widespread agreement that the Directive has a number of important deficiencies, and although attempts have been made to address those deficiencies ever since its introduction, those attempts ultimately yielded no results. Another illustration of this is the lack of a general subject-to-tax requirement (see above). There was an expectation that the introduction of the "Pillar 2 Directive"[38] would provide an impetus for amending the Directive to include a "minimum effective taxation" clause.[39] Again, however, progress on this issue seems to have stalled since then. It seems, in other words, that the Directive is quite resistant to change. **12.020**

D. GENERAL REMARKS ON THE COMMENTARY

The present volume intends to offer in-depth commentary on the different provisions of the Interest & Royalty Directive as it currently reads. For ease of reference, the text of the relevant provision is reproduced at the beginning of each chapter. The annex, which lists the companies referred to in Article 3(a)(i) of the Directive, is included at the end of the commentary on Article 3. **12.021**

37 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, COM(2009)179, 10.

38 Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, OJ L 328, 22.12.2022, 1-58.

39 On that concept, see J. Vleggert and H. Vording, 'Conditional Withholding Tax: A Tax on Tax Planning' (2017) Bulletin for International Taxation, issue 8, 456. On the possibility of drawing inspiration from the OECD work on Pillar 2 (particularly relating to the Subject to Tax Rule), see A. Forteza, 'Convergence between the Subject to Tax Rule (Pillar Two) and the 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' (2024) EC Tax Review, issue 4, 172-178.

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ARTICLE 1: SCOPE AND PROCEDURE

Carla De Pietro

1. **Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State.**
2. **A payment made by a company of a Member State or by a permanent establishment situated in another Member State shall be deemed to arise in that Member State, hereafter referred to as the 'source State'.**
3. **A permanent establishment shall be treated as the payer of interest or royalties only insofar as those payments represent a tax-deductible expense for the permanent establishment in the Member State in which it is situated.**
4. **A company of a Member State shall be treated as the beneficial owner of interest or royalties only if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory, for some other person.**
5. **A permanent establishment shall be treated as the beneficial owner of interest or royalties:**
   (a) **if the debt-claim, right or use of information in respect of which interest or royalty payments arise is effectively connected with that permanent establishment; and**
   (b) **if the interest or royalty payments represent income in respect of which that permanent establishment is subject in the Member State in which it is situated to one of the taxes mentioned in Article 3(a)(iii) or in the case of Belgium to the 'impôt des non-résidents/belasting der niet-verblijfhouders' or in the case of Spain to the 'Impuesto sobre la Renta de no Residentes' or to a tax which is identical or substantially similar and which is imposed after the date of entry into force of this Directive in addition to, or in place of, those existing taxes.**
6. **Where a permanent establishment of a company of a Member State is treated as the payer, or as the beneficial owner, of interest or royalties, no other part of the company shall be treated as the payer, or as the beneficial owner, of that interest or those royalties for the purposes of this Article.**

7. **This Article shall apply only if the company which is the payer, or the company whose permanent establishment is treated as the payer, of interest or royalties is an associated company of the company which is the beneficial owner, or whose permanent establishment is treated as the beneficial owner, of that interest or those royalties.**
8. **This Article shall not apply where interest or royalties are paid by or to a permanent establishment situated in a third State of a company of a Member State and the business of the company is wholly or partly carried on through that permanent establishment.**
9. **Nothing in this Article shall prevent a Member State from taking interest or royalties received by its companies, by permanent establishments of its companies or by permanent establishments situated in that State into account when applying its tax law.**
10. **A Member State shall have the option of not applying this Directive to a company of another Member State or to a permanent establishment of a company of another Member State in circumstances where the conditions set out in Article 3(b) have not been maintained for an uninterrupted period of at least two years.**
11. **The source State may require that fulfilment of the requirements laid down in this Article and in Article 3 be substantiated at the time of payment of the interest or royalties by an attestation. If fulfilment of the requirements laid down in this Article has not been attested at the time of payment, the Member State shall be free to require deduction of tax at source.**
12. **The source State may make it a condition for exemption under this Directive that it has issued a decision currently granting the exemption following an attestation certifying the fulfilment of the requirements laid down in this Article and in Article 3. A decision on exemption shall be given within three months at most after the attestation and such supporting information as the source State may reasonably ask for have been provided, and shall be valid for a period of at least one year after it has been issued.**
13. **For the purposes of paragraphs 11 and 12, the attestation to be given shall, in respect of each contract for the payment, be valid for at least one year but for not more than three years from the date of issue and shall contain the following information:**
    (a) **proof of the receiving company's residence for tax purposes and, where necessary, the existence of a permanent establishment certified by the tax authority of the Member State in which the receiving company is resident for tax purposes or in which the permanent establishment is situated;**
    (b) **beneficial ownership by the receiving company in accordance with paragraph 4 or the existence of conditions in accordance with paragraph 5 where a permanent establishment is the recipient of the payment;**
    (c) **fulfilment of the requirements in accordance with Article 3(a)(iii) in the case of the receiving company;**
    (d) **a minimum holding or the criterion of a minimum holding of voting rights in accordance with Article 3(b);**

(e) **the period for which the holding referred to in (d) has existed.**

Member States may request in addition the legal justification for the payments under the contract (e.g. loan agreement or licensing contract).

14. **If the requirements for exemption cease to be fulfilled, the receiving company or permanent establishment shall immediately inform the paying company or permanent establishment and, if the source State so requires, the competent authority of that State.**
15. **If the paying company or permanent establishment has withheld tax at source to be exempted under this Article, a claim may be made for repayment of that tax at source. The Member State may require the information specified in paragraph 13. The application for repayment must be submitted within the period laid down. That period shall last for at least two years from the date when the interest or royalties are paid.**
16. **The source State shall repay the excess tax withheld at source within one year following due receipt of the application and such supporting information as it may reasonably ask for. If the tax withheld at source has not been refunded within that period, the receiving company or permanent establishment shall be entitled on expiry of the year in question to interest on the tax which is refunded at a rate corresponding to the national interest rate to be applied in comparable cases under the domestic law of the source State.**

COMMENTARY

A. FUNCTIONING AND SCOPE OF APPLICATION

1. Objective and subjective scope of application

Article 1(1) of the Interest and Royalties Directive (IRD)[1] defines the fundamental mechanism underlying the functioning of the entire IRD, i.e., an exemption in the State of source from any taxes imposed on interest or royalty payments, "provided that" the recipient of these payments qualifies as beneficial owner and is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State. Therefore, the IRD aims to tax interest and royalties in the State of the beneficial owner, where the related expenditure will normally have been deducted.[2] **13.001**

It is clear from the other paragraphs of Art. 1 that – in order for the IRD to apply – interest and royalty payments must also be made by a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State. The subjective scope of the IRD, therefore, also extends to permanent establishments. This implies, as will be also shown below, that the IRD – differently from bilateral tax treaties – also deals with triangular[3] or even quadrangular[4] cases.[5] These triangular and quadrangular situations may give rise to complex interpretative issues.[6] These issues will be considered below to the extent that they specifically arise from the provisions contained in Art. 1 of the IRD. **13.002**

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1 Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

2 *See* European Commission, 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, COM(2009) 179 final, p. 3. *See also* S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 499.

3 When a permanent establishment is involved either as payer or as recipient (beneficial owner).

4 When two permanent establishments are involved as payer and recipient (beneficial owner).

5 D. Hristov, 'Chapter 7 – The Interest and Royalties Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde 2020), 202; S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 513.

6 *See* M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 1' (2005) European Taxation, issue 1; M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 2' (2005) European Taxation, issue 2; M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 1' (2005) European Taxation, issue 3.

13.003 According to Art. 1(7), the IRD only applies to payments between associated companies (or permanent establishments of associated companies).[7] Therefore, the Directive specifically concerns intra-EU cross-border interest and royalty payments between associated companies and/or permanent establishments that are part of the same group. Accordingly, Art. 1(8) specifies that the IRD does not apply when interest or royalty payments are made or received (beneficial owner) by a permanent establishment in a third State of a company of a Member State and the business activity of the company is entirely or partially carried on through that permanent establishment.[8]

13.004 According to Art. 1(2) IRD, a payment made by a company of a Member State or by a permanent establishment situated in another Member State shall be deemed to arise in that Member State, which will qualify as the "source State." Subsequently, Art. 1(3) clarifies that a permanent establishment can be treated as the payer of interest or royalties only if these payments "represent a tax-deductible expense" for the permanent establishment in the Member State in which it is situated.[9] In literature, it has been pointed out that this provision may result in discriminatory treatment for permanent establishments vis-à-vis companies, therefore advancing a possible breach of EU primary law. In fact, a Member State where interest and royalty payments are not deductible may grant the exemption when the payer is a company while denying the exemption in similar circumstances when the payer is a permanent establishment.[10] The major interpretative issue concerns whether Art. 1(3) requires an effective deduction in order for the permanent establishment to qualify as payer under the IRD or whether the mere deductibility of the payments under domestic law would be sufficient.[11] The issue has been raised also by the Commission

7 *See also* Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, Preamble recital 4.

8 *See also* D. Hristov, 'Chapter 7 – The Interest and Royalties Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde 2020), 201.

9 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 510; D. Hristov, 'Chapter 7 – The Interest and Royalties Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde 2020), 208.

10 D. Hristov, 'Chapter 7 – The Interest and Royalties Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde 2020), 208; S. Fernandes e.a., 'A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 1' (2011) European Taxation, issue 9-10, 407; M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, 151.

11 *See*, for example, S. Fernandes e.a., 'A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 1' (2011) European Taxation, issue 9-10, 408; J. López Rodriguez, 'Chapter 8 Commentary on the Interest and Royalties Directive' in EC Corporate Tax Law - Commentary on the EC Direct Tax Measures and Member States Implementation, Supplement no. 36 (2008), 52-53.

in the 2009 report to the Council (the 2009 report). While the Commission states that "[i]t is clear from the context that the purpose of the 'tax-deductibility' requirement is to ensure that the benefits of the Directive accrue only in respect of those payments that represent expenses which are attributable to the PE",[12] at the same time it expressly recognizes that the wording of the provision is not clear in this respect and that it could lead to requiring effective deduction. Therefore, the Commission concludes on the point: *"[i]n order to avoid an unjustifiable difference of treatment as between a subsidiary and a PE [emphasis added]*, consideration might be given to rewording Article 1(3) in order to make it more precise".[13]

Art. 1(1) does not expressly state whether the IRD only concerns cases of juridical double taxation – being the recipient (beneficial owner) of the interest or royalty payments the exclusive beneficiary of the tax exemption – or whether also cases of economic double taxation – therefore, requiring tax exemption also in the hands of the payer – are covered.[14] The decision of the Court of Justice of the European Union (CJEU) in the Scheuten Solar Technology GmbH case[15] has clarified this aspect. In the judgment at issue, which will be further analyzed below, when specifically discussing the concept of beneficial owner, the CJEU has excluded the breach of Art. 1(1) IRD through a German tax provision adding back half of the amount of deducted loan interest – in the case at issue paid by a company established in a Member State to an associated company in another Member State – by the debtor to the business tax base of the payer.[16] The Court stated[17] that the tax exemption under Art. 1(1) IRD only concerns the beneficial owner/creditor of the income (elimination of juridical double taxation) and not the payer/debtor of the income (elimination **13.005**

12 European Commission, 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, COM(2009) 179 final, p. 4. *See also* J. López Rodriguez, 'Chapter 8 Commentary on the Interest and Royalties Directive' in EC Corporate Tax Law - Commentary on the EC Direct Tax Measures and Member States Implementation, Supplement no. 36 (2008), 54. For a different position, *see* S. Fernandes e.a., 'A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 1' (2011) European Taxation, issue 9-10, 408-409.

13 European Commission, 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, COM(2009) 179 final, p. 4.

14 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 516.

15 Case C-397/09 Scheuten Solar Technology GmbH [2011] EU:C:2011:499. *See also* J. Englisch, 'Germany II: The Mattner Case and the Scheuten Solar Technology GmbH Case' in M. Lang et al (eds), *ECJ – Recent Developments in Direct Taxation 2009*, *Series on International Tax Law* (Linde 2010), 94-109.

16 Case C-397/09 Scheuten Solar Technology GmbH [2011] EU:C:2011:499, paras. 7-12.

17 Case C-397/09 Scheuten Solar Technology GmbH [2011] EU:C:2011:499, paras. 24-34.

of economic double taxation).[18] In light of this decision, in literature it is argued that national rules against thin capitalization and earnings stripping are outside the scope of the IRD. On the basis of the same reasoning, it is also excluded a conflict between the IRD and the "interest limitation rule" under Art. 4 of the Anti-Tax Avoidance Directive (ATAD).[19, 20]

13.006 The fact that the scope of Art. 1(1) IRD is limited to the avoidance of juridical double taxation in the hands of the beneficial owner has arguably consequences for the interpretation of Art. 1(6) of the IRD. According to this provision: "[w]here a permanent establishment of a company of a Member State is treated as the payer, or as the beneficial owner, of interest or royalties, no other part of the company shall be treated as the payer, or as the beneficial owner, of that interest or those royalties for the purposes of this Article". An additional instance of juridical double taxation may arise when a permanent establishment (and not the relevant company) is treated as the payer (therefore, only the State where the permanent establishment is situated is identified as the source State under Art. 1(6), in connection with Art. 1(2)).[21] In this case, the question is whether interest or royalties may consequently be taxed also in the State of residence of the company of the permanent establishment. In this triangular situation, this additional instance of juridical double taxation would also affect the position of the beneficial owner (the creditor of the income), i.e., reducing the received income.[22] In fact, juridical double taxation in the hands of the beneficial owner would not be completely[23] eliminated.[24] Thus, it can

18 *See also* S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 517; S. Fernandes e.a., 'A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 2' (2011) European Taxation, issue 11, 457- 458.

19 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 1–14.

20 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 517; D. Hristov, 'Chapter 7 – The Interest and Royalties Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde 2020), 197 and 206; T. van Dongen, 'Thin Capitalization Legislation and the EU Corporate Tax Directives' (2012) European Taxation, issue 1, 21-24. For a different position, *see* S. Fernandes e.a., 'A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 2' (2011) European Taxation, issue 11, 458.

21 J. López Rodriguez, 'Chapter 8 Commentary on the Interest and Royalties Directive' in EC Corporate Tax Law - Commentary on the EC Direct Tax Measures and Member States Implementation, Supplement no. 36 (2008), 59; M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 1' (2005) European Taxation, issue 2, 46.

22 Case C-397/09 Scheuten Solar Technology GmbH [2011] EU:C:2011:499, para. 28 (and especially the reference to "the detriment of the actual beneficial owner") and para. 30.

23 Case C-397/09 Scheuten Solar Technology GmbH [2011] EU:C:2011:499, para. 24 (and especially the reference to "the abolition of all taxation of those payments").

24 *See also* Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, Preamble recitals 1 to 4.

be argued that this triangular situation is covered by the IRD and, therefore, also the Member State of the company should exempt the interest or royalty payment.[25]

According to Art. 1(9) IRD: "[n]othing in this Article shall prevent a Member State from taking interest or royalties received by its companies, by permanent establishments of its companies or by permanent establishments situated in that State into account when applying its tax law". This provision is coherent with the Preamble of the IRD, according to which taxation of interest and royalty payments must be granted at least once[26] in a Member State.[27] Art. 1(9) should also be interpreted in light of the scope of Art. 1(1), as clarified by the CJEU in the Scheuten Solar Technology GmbH case. If Art. 1(1) is considered as only concerning the avoidance of juridical double taxation in the hands of the beneficial owner, then the IRD does not cover instances of juridical double taxation outside this delineated scope that may arise in light of Art. 1(9). This is the case when the interest or royalty payment is beneficially owned by a permanent establishment. In this triangular situation – in light of Art. 1(9) – also the Member State where the company of the permanent establishment is resident may tax the relevant interest or royalty payment. This instance of juridical double taxation, not reducing the income of the beneficial owner (creditor of the income), is outside the scope of the IRD. Consequently, in **13.007**

25 J. López Rodriguez, 'Chapter 8 Commentary on the Interest and Royalties Directive' in EC Corporate Tax Law - Commentary on the EC Direct Tax Measures and Member States Implementation, Supplement no. 36 (2008), 59. For a different position, *see* M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 1' (2005) European Taxation, issue 2, 47- 48.

26 *See*, for example, S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 499; D. Weber, 'EU Beneficial Ownership Further Developed: A View from a Different Angle' (2022) World Tax Journal, issue 1, 54; Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16 N Luxembourg 1 and Others v Skatteministeriet [2019] ECLI:EU:C:2019:134, paras. 85 and 152 (hereafter the 'Danish IRD Cases'); J. López Rodriguez & G. Kofler, Chapter 16 *Beneficial Ownership and EU Law*, in M. Lang et al (eds), *Beneficial Ownership: Recent Trends*, IBFD (2013), pp. 217-218; European Commission, 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, COM(2009) 179 final, 3. For a different interpretation of the Preamble on this point, *see* P. Arginelli, 'Open Issues in the Application of the Interest and Royalty Directive to Royalty Payments' in G. Maisto (ed.), *Taxation of Intellectual Property under Domestic Law, EU Law and Tax Treaties*, (IBFD 2018), 65.

27 Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, Preamble recital 4. *See also* J. López Rodriguez, 'Chapter 8 Commentary on the Interest and Royalties Directive' in EC Corporate Tax Law - Commentary on the EC Direct Tax Measures and Member States Implementation, Supplement no. 36 (2008), 57.

these cases, juridical double taxation may only be prevented through domestic unilateral measures or double tax treaties.[28]

2. Minimum Association Period

13.008 Art. 1(10) recognizes Member States the option of not guaranteeing the benefits of the IRD to a company of another Member State or to a permanent establishment of a company of another Member State in case the association requirements indicated in Art. 3(b) IRD "have not been maintained for an uninterrupted period of at least two years". Art. 1(10) is generally considered a specific[29] anti-abuse provision aimed at guaranteeing that the association requirements are genuinely met.

13.009 The provisions contained in Art. 1(10) IRD are similar to those in Art. 3(2)(b) of the Parent-Subsidiary Directive.[30] In the Denkavit case,[31] the CJEU has ruled, with reference to the latter Directive, that Art. 3(2)(b)[32] cannot be interpreted as requiring that the uninterrupted period of at least two years must be completed at the time when the tax advantage is granted. According to the Court, as Art. 3(2)(b) represents a derogation from the principle of exemption from withholding taxes, consequently also disrupting the objective of the Directive to guarantee equal tax treatment between national and cross-border cooperation between companies, it must be interpreted strictly. Thus, Member States cannot unilaterally introduce restrictions, for example

28 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 518; J. López Rodriguez, 'Chapter 8 Commentary on the Interest and Royalties Directive' in EC Corporate Tax Law - Commentary on the EC Direct Tax Measures and Member States Implementation, Supplement no. 36 (2008), 57.

29 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 508; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 216-217 (and, in particular, footnote no. 9); European Commission, 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, COM(2009) 179 final, p. 5; J. López Rodriguez, 'Chapter 8 Commentary on the Interest and Royalties Directive' in EC Corporate Tax Law - Commentary on the EC Direct Tax Measures and Member States Implementation, Supplement no. 36 (2008), 24; M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, 151; D. Weber, 'The proposed EC Interest and Royalty Directive' (2000) EC Tax Review, issue 1, 24; J.D.B. Oliver, 'The Proposed EU Interest and Royalties Directive' (1999) Intertax, issue 6-7, 205-206.

30 Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast).

31 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387.

32 At the time of the judgment, it was the second indent of Art. 3(2).

implying, as in the Denkavit case, that the uninterrupted period of at least two years is completed at the time of distribution of the relevant profits.[33]

The interpretative approach of the Court in the Denkavit case is also based on the wording of Art. 3(2)(b), which uses the present tense, recognizing the option of not granting the benefits of the Directive to companies that "do not maintain" the qualifying shareholding for a certain uninterrupted minimum period.[34] There is, therefore, a difference compared to Art. 1(10) IRD that, as indicated above, uses a different tense ("have not been maintained"). However, in the 2009 report of the Commission as well as in literature, it is concluded that this difference does not preclude an application by analogy of the reasoning in the Denkavit case to Art. 1(10) IRD. First of all, also Art. 1(10) represents a derogation from exemption in the source State, consequently disrupting the objective of the IRD consisting in guaranteeing equal tax treatment between national and cross-border interest and royalty payments.[35] Therefore, also Art. 1(10) should be interpreted strictly. Furthermore, notwithstanding that the 1998 IRD proposal already used the wording "have not been maintained", in the relevant Explanatory Memorandum, with reference to the then Art. 3(2) IRD, it was stated: "[m]ember States may not make the granting of the tax advantage provided for by the Directive subject to the condition that, at the moment of the payment of the interest or royalties, this holding period has already been completed, so long as it is subsequently observed".[36, 37] Finally, it is also relevant to note that in the Denkavit case the Court mentioned that, although the Danish language version of Art. 3(2)(b) of the Parent-Subsidiary Directive used "a past tense", this would not imply a different interpretation.[38] **13.010**

33 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387, paras. 22-32.

34 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387, paras. 24-25.

35 European Commission, 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, COM(2009) 179 final, 4-5; J. López Rodriguez, 'Chapter 8 Commentary on the Interest and Royalties Directive' in EC Corporate Tax Law - Commentary on the EC Direct Tax Measures and Member States Implementation, Supplement no. 36 (2008), 25.

36 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, 7-8.

37 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 509.

38 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387, para. 25. *See also* J. López Rodriguez, 'Chapter 8 Commentary on the Interest and Royalties Directive' in EC Corporate Tax Law - Commentary on the EC Direct Tax Measures and Member States Implementation, Supplement no. 36 (2008), 25.

13.011 In the Denkavit case, the Court also argued that, under the Parent-Subsidiary Directive, Member States could not be considered obliged to grant the exemption from the beginning of the holding period "without being certain of being able to obtain payment of the tax later, in the event that the parent company fails to observe the minimum holding period which the Member State has laid down".[39] However, in the 2009 report, the Commission argued that, after the entry into force of Directive 2001/44/EC[40] (now Directive 2010/24/EU[41]) concerning mutual assistance for the recovery of tax claims, this position of the Court can no longer be considered relevant. Consequently, occurring the association requirements under Art. 3(b) IRD, the State of source should, in any case, grant the exemption immediately.[42]

3. Tax exemption and procedural aspects

13.012 According to Article 1(1) of the IRD, and occurring all relevant conditions, an exemption must be granted in the State of source from "any taxes", regardless of whether they are levied by deduction at source or by assessment. The objective of the Directive, consisting in guaranteeing equal tax treatment of cross-border transactions vis-à-vis purely domestic intra-group transactions, implies not only the elimination of juridical double taxation but also the avoidance of "burdensome administrative formalities" as well as "cash-flow problems".[43] Thus, the administrative procedures indicated in Art. 1(11) to (16) aim to guarantee immediate full exemption.[44]

13.013 It is also pointed out that, while the procedural rules under Art. 1(11) to (16) expressly refer only to taxation "by deduction at source", they should be

39 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387, para. 33.

40 Council Directive 2001/44/EC of 15 June 2001 amending Directive 76/308/EEC on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund, and of agricultural levies and customs duties and in respect of value added tax and certain excise duties.

41 Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties, and other measures.

42 European Commission, 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, COM(2009) 179 final, p. 5. *See also* S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 509.

43 Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, Preamble recitals 1 to 4.

44 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 516.

considered to apply by analogy also to taxation at source "by assessment", in line with Art. 1(1).[45]

Under Art. 1(11), the source State may require the recipient company or permanent establishment to provide an attestation at the time of payment demonstrating the occurrence of the conditions necessary to obtain the exemption according to Articles 1 and 3 IRD. Lacking this attestation at the time of payment, the source State is allowed to tax interest or royalties. Art. 1(12) further establishes that, in order to grant the exemption, the source State may also require a positive decision of its administration assessing, on the basis of the above-mentioned attestation, the occurrence of the conditions under Articles 1 and 3. This decision shall be given within three months from when the attestation and further supporting information reasonably requested by the source State are provided. This decision shall be considered valid for at least one year after it has been issued. According to Art. 1(13), the attestation shall be valid for at least one year and no longer than three years from the date of issuance. This attestation shall contain the following information: **13.014**

(a) proof of the receiving company's residence for tax purposes and, where necessary, the existence of a permanent establishment certified by the tax authority of the Member State in which the receiving company is resident for tax purposes or in which the permanent establishment is situated;
(b) beneficial ownership by the receiving company in accordance with paragraph 4 or the existence of conditions in accordance with paragraph 5 where a permanent establishment is the recipient of the payment;
(c) fulfilment of the requirements in accordance with Article 3(a)(iii) in the case of the receiving company;
(d) a minimum holding or the criterion of a minimum holding of voting rights in accordance with Article 3(b);
(e) the period for which the holding referred to in (d) has existed.

Furthermore, the source State may request the contract justifying the payment(s), like – for example – the loan agreement or the licensing contract. **13.015**

Art. 1(14) further establishes that, in case the conditions justifying the exemption no longer occur, then the receiving company or permanent establishment shall immediately inform the paying company or permanent establishment. The source State can additionally require informing the competent authority there. **13.016**

45 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 518. *See also* D. Hristov, 'Chapter 7 – The Interest and Royalties Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde 2020), 197.

13.017 Art. 1(15) expressly recognizes the possibility of claiming the repayment of the tax withheld at source, giving the possibility to the beneficial owner to demonstrate that interest or royalties should have been exempted. The proof concerns the information indicated in Art. 1(13). It is up to the source State to determine the period within which this claim can be submitted, but this period shall last for at least two years from the date of the payment. Finally, Art. 1(16) establishes that the source State shall repay the tax withheld within one year of the beneficial owner demonstrating that interest or royalties should have been exempted. If the source State repays after this 1-year period, the beneficial owner has the right to receive interest on the amount refunded at a rate applied under the domestic law of the source State in comparable cases.

13.018 On the 4th of December 2024, the Czech Supreme Administrative Court requested a preliminary ruling from the CJEU[46] concerning a case in which the procedural requirements for the obtainment of full exemption had not been fulfilled at the time of payment. More in particular, under Czech domestic law, a positive decision of the tax administration is required – in accordance with Art. 1(12) IRD – in order to obtain the exemption. In the case at issue, no taxes had been levied in the State of source when the application for a decision was submitted. The decision was requested in 2019, but with reference to the tax periods 2014-2018. Therefore, this decision was meant to have retroactive effect.

13.019 During the national proceedings of the case, the request of the applicant was accepted only with reference to the previous two years (2017-2018), i.e., with reference to the period within which Art. 1(15) IRD allows (as a minimum requirement) taxes to be refunded (although in the case at issue no taxes had actually been levied). Therefore, this provision under Art. 1(15) IRD was considered to apply with direct effect. The request of the applicant was, consequently, rejected with reference to the years 2014-2016.

13.020 The Czech Supreme Administrative Court doubts whether the IRD can be interpreted as allowing that, on the basis of a positive decision of the tax administration under Art. 1(12), the attestation and further supporting information reasonably requested by the source State, or the positive decision of the tax administration may also have retroactive effect, therefore granting the exemption with reference to a period preceding the time when the attestation

46 Pending Case C-828/24, Erdrich Umformtechnik. The case is described based on the information available on the website of the Court of Justice of the European Union (https://curia.europa.eu/jcms/jcms/j_6/en/) at the time of writing this contribution (last accessed February 2025).

and further information are provided, or the decision is issued. In the affirmative, the Supreme Administrative Court asks whether there is any time limit – deriving directly or indirectly from the IRD or, in any case, EU law – that a Member State may require for the provision of the attestation and further supporting information, for the purposes of a decision under Art. 1(12), or any time limit concerning the length of the period preceding the provision of the attestation and further supporting information in respect of which a tax exemption can be granted (i.e., limited retroactive effect).

B. THE CONCEPT OF BENEFICIAL OWNER UNDER THE IRD AND ITS INTERPRETATION

1. The function of the beneficial owner concept under the IRD

The 1990 IRD proposal[47] of the Commission did not contain any reference to the concept of beneficial owner. This concept was introduced in the 1998 IRD proposal[48] and modified – as will be indicated below – through the process of adoption of the Directive until 2003.[49] **13.021**

The IRD defines the concept of beneficial owner in Art. 1(4) with reference to a company of another Member State, and in Art. 1(5) with reference to a permanent establishment situated in another Member State of a company of a Member State. Accordingly, in order to obtain the exemption in the source State and, therefore, to benefit from the advantages of the harmonized regime, the recipient of interest or royalties must qualify as beneficial owner under these provisions. **13.022**

The Preamble of the IRD[50] identifies the guarantee of equal tax treatment between national and cross-border payments of interest and royalties, through the elimination of double taxation as well as burdensome administrative **13.023**

47 Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, COM(90)571 final.

48 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.

49 J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 216-221.

50 Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, Preamble recitals 2 to 4. *See also* 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, p. 3.

procedures and cash flow problems, as the objective of the Directive.[51] At the same time, in the Preamble it is pointed out the need of assuring that interest and royalty payments are taxed at least once in a Member State. Although in the Preamble there is no reference to the concept of beneficial owner, in the Scheuten Solar Technology GmbH case,[52] as already considered above, the CJEU has clarified that by subordinating ("provided that") the exemption in the Member State of source, where interest and royalty payments arise, to the qualification of the recipient as beneficial owner, Art. 1(1) of the IRD limits the personal scope of the Directive. In fact, according to the Court, the IRD is only concerned with the elimination of double taxation in the hands of the recipient of the payment qualifying as the "actual beneficial owner"[53] (juridical double taxation) and not with the elimination of double taxation in the hands of the payer (economic double taxation). The Court supports this interpretative approach also by referring to Art. 1(10) of the IRD, and more in particular – as already considered above – to the fact that the possibility for the Member State of source to disapply the IRD is specifically connected only "to a company of another Member State or to a permanent establishment of a company of another Member State" (i.e., the beneficial owner). Therefore, also the scope of this provision does not include the payer of the interest or royalties.[54]

13.024 As a determinant of the personal scope of the IRD, the beneficial ownership clause qualifies as one of the specific[55] anti-abuse provisions contained in the Directive, aiming at guaranteeing effective taxation (only) in the State of the "actual" beneficiary. Accordingly, in the Danish cases on interest, the CJEU – in light of the 1977 OECD Model Tax Convention and the relevant Commentaries (including the 2003 revisions) – recognized this double function of the beneficial owner concept under the IRD by stating that "the concept of 'beneficial owner' excludes conduit companies and must be understood not in a narrow technical sense but as having a meaning that enables double

51 *See also* S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 497-498.

52 Case C-397/09 Scheuten Solar Technology GmbH [2011] EU:C:2011:499.

53 Case C-397/09 Scheuten Solar Technology GmbH [2011] EU:C:2011:499, para. 27.

54 Case C-397/09 Scheuten Solar Technology GmbH [2011] EU:C:2011:499, paras. 24-29.

55 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 519-520; C. Hamra & J. Korving, 'Beneficial Ownership Interpreted, To What Extent Are the OECD and the EU on the Same Wavelength?' (2021) Intertax, issue 3, 267; P. Arginelli, 'Open Issues in the Application of the Interest and Royalty Directive to Royalty Payments' in G. Maisto (ed.), *Taxation of Intellectual Property under Domestic Law, EU Law and Tax Treaties*, (IBFD 2018), 75; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 217, 234, 243-244; M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, 151.

taxation to be avoided and tax evasion and avoidance to be prevented".[56] In fact, the Commission had already pointed out that the requirement for the recipient of interest and royalty payments to qualify as beneficial owner "is specifically designed to tackle artificial conduit arrangements".[57] Thus, according to the Commission, this requirement aims at avoiding the artificial interposition of an intermediary when the subject directly receiving the interest or royalty payment does not qualify for the benefits of the IRD (for example, a company in a third State).[58]

2. Beneficial owner as an EU concept and the relevance of the OECD Model Tax Convention and Commentaries

In the 2009 report, the Commission expressly pointed out the EU nature of the beneficial owner concept under the IRD, emphasizing the need to guarantee the effectiveness of the Directive through a harmonized approach. In fact, the application of different definitions or interpretations may lead to different treatments of similar situations. The exemption under Art. 1(1) IRD may be guaranteed by some Member States in some circumstances, while denied by other Member States in similar circumstances. It is, therefore, crucial that the concept of beneficial owner is uniformly applied and interpreted throughout the European Union.[59] This position of the Commission has also been confirmed by the CJEU in the Danish cases on interest. As stated by the Court, "the concept of 'beneficial owner of the interest', which appears in Article 1(1) of Directive 2003/49, cannot refer to concepts of national law that vary in scope".[60] Accordingly, the Court reconnects the EU nature of the beneficial **13.025**

56 Danish IRD Cases, para. 92.

57 European Commission, 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, COM(2009) 179 final, 8.

58 European Commission, 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, COM(2009) 179 final, 3. *See also* S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 511; D. Hristov, 'Chapter 7 – The Interest and Royalties Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde 2020), 208; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 218; J. López Rodriguez, 'Chapter 8 Commentary on the Interest and Royalties Directive' in EC Corporate Tax Law - Commentary on the EC Direct Tax Measures and Member States Implementation, Supplement no. 36 (2008), 54.

59 European Commission, 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, COM(2009) 179 final, p. 4.

60 Danish IRD Cases, para. 84. *See also* S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 511; L. De Broe and S. Gommers, 'Danish Dynamite: The 26 February 2019

owner concept with the need to ensure that double taxation is eliminated and tax avoidance and evasion prevented, thus achieving the final objective to guarantee equal tax treatment between domestic and cross-border payments of interest and royalty.[61]

13.026 Also very important, in the Danish cases on interest, the CJEU acknowledged the relevance of the OECD Model Tax Convention and its Commentaries (including "the successive amendments of that model and of the commentaries relating thereto")[62, 63] when interpreting the EU concept of beneficial owner under the IRD.[64] According to the Court, the 1998 IRD proposal, on which the 2003 Directive is based, shows that "the directive draws upon Article 11 of the OECD 1996 Model Tax Convention and pursues the same objective, namely avoiding international double taxation".[65] The Court also clarified that the acknowledged relevance of the OECD Model Tax Convention and its Commentaries does not undermine the democratic legitimacy of the proposed interpretative approach, which in any case recognizes "the directive itself", including "its legislative history", as the basis for the interpretation of the EU beneficial owner concept.[66] In this respect, it is actually important to highlight that – in fact – the 1998 IRD proposal does not refer to the OECD Model

CJEU Judgments in the Danish Beneficial Ownership Cases' (2019) EC Tax Review, issue 6, 291; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 220; D. Weber, 'The proposed EC Interest and Royalty Directive' (2000) EC Tax Review, issue 1, 22.

61 Danish IRD Cases, paras. 84-94.

62 Danish IRD Cases, para. 90. *See* the different position of Advocate General Kokott: Opinion of Advocate General Kokott, delivered on 1 March 2018 in case C-115/16, N Luxembourg 1 *v* Skatteministeriet, para. 55. *See also* Opinion of Advocate General Kokott, delivered on 1 March 2018 in case C-118/16, X Denmark A/S *v* Skatteministeriet, para. 55; Opinion of Advocate General Kokott, delivered on 1 March 2018 in case C-119/16, C Danmark I *v* Skatteministeriet, para. 55; Opinion of Advocate General Kokott, delivered on 1 March 2018 in case C-299/16, Z Denmark v Skatteministeriet, para. 55.

63 On uncertainties regarding the ambulatory interpretative approach of the CJEU on this aspect in the Danish cases on interest, *see* Confédération Fiscale Européenne, 'Opinion Statement ECJ-TF 2/2019 on the ECJ Decisions of 26 February 2019 in N Luxembourg I et al. (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) and T Danmark et al. (Joined Cases C-116/16 and C-117/17), Concerning the "Beneficial Ownership" Requirement and the Anti-Abuse Principle in the Company Tax Directives' (2019) European Taxation, issue 10, 498.

64 *See also* S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 500-502.

65 Danish IRD Cases, para. 90.

66 Danish IRD Cases, para. 91.

Tax Convention or its Commentaries with specific reference to the concept of beneficial owner.[67, 68]

In any case, in light of the position of the Court in the Danish cases on interest, the concept of beneficial owner must be interpreted on the basis of the IRD, while also taking into consideration the OECD Model Tax Convention and its Commentaries, including the successive versions of both of them. Therefore, the acknowledged EU nature of the beneficial owner concept under the IRD has to be reconciled with the recognized relevance of the corresponding concept at the OECD level. In fact, on the one hand, it is required the application of a uniform EU concept of beneficial owner guarantees the harmonized regime adopted with the IRD, while – on the other hand – also the OECD present and future positions may be relevant when interpreting this concept. The core problem in this respect is that the Court has not clarified to what extent the OECD positions can be considered relevant.[69] This approach undermines legal certainty and requires interpretative considerations on a case-by-case basis. **13.027**

3. The definition of beneficial owner under Art. 1(4) IRD and its interpretation

(a) General

Art. 1(4) IRD establishes that a company receiving interest or royalty payments qualifies as beneficial owner when the payments are received (i) for its own benefit, and (ii) not as an intermediary, such as an agent, trustee or authorized signatory. This definition is, therefore, based on two components **13.028**

67 The only express references to the OECD Model Tax Convention are contained in the Explanatory Memorandum commenting on Articles 2 (definitions of "interest" and "royalties") and 5 (exclusion of non-arm's length payments). *See* 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, 6 and 8.

68 *See also* Confédération Fiscale Européenne, 'Opinion Statement ECJ-TF 2/2019 on the ECJ Decisions of 26 February 2019 in N Luxembourg I et al. (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) and T Danmark et al. (Joined Cases C-116/16 and C-117/17), Concerning the "Beneficial Ownership" Requirement and the Anti-Abuse Principle in the Company Tax Directives' (2019) European Taxation, issue 10, 497.

69 *See also* C. De Pietro, 'Beneficial Ownership, Tax Abuse and Legal Pluralism: An Analysis in Light of the CJEU's Judgment Concerning the Danish Cases on Interest' (2020) Intertax, issue 12, 1077; Confédération Fiscale Européenne, 'Opinion Statement ECJ-TF 2/2019 on the ECJ Decisions of 26 February 2019 in N Luxembourg I et al. (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) and T Danmark et al. (Joined Cases C-116/16 and C-117/17), Concerning the "Beneficial Ownership" Requirement and the Anti-Abuse Principle in the Company Tax Directives' (2019) European Taxation, issue 10, 497- 498.

– a positive and a negative one – that must be considered together when assessing the status of beneficial owner.[70]

13.029 This current definition of beneficial ownership seems to reflect the position already taken by the European Commission in the 1998 IRD proposal. The commentary on Art. 3(1)(c) explained that: "[t]he notion of beneficial owner is intended to secure that the exemption applies when an *intermediary, such as [emphasis added]* an agent or nominee or trustee, is interposed between the beneficiary and the payer, only if the true owner of the interest or royalty payments meets the requirements of the Directive".[71] However, the interpretation given in this commentary was not clearly reflected in the text of Art. 3(1)(c) of the 1998 IRD proposal, which stated "the 'beneficial owner' of payments of interest or royalties is a company of a Member State or a permanent establishment which holds those payments for its own benefit and not as an agent, trustee or nominee for some other person".[72] This text – contrary to the related commentary – did not use the term "intermediary" and – by not using the expression "as such" – seemed to indicate an exhaustive list of subjects not qualifying as beneficial owners when referring to "agent, trustee or nominee".[73] Therefore, the final changes as resulted in the text of Art. 1(4) IRD as adopted in 2003, which have actually aligned the textual definition with the original approach of the Commission (at least as expressed in the above-mentioned commentary).[74]

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70 Danish IRD Cases, para. 88. *See also* S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 511; S. Baerentzen, 'Danish Cases on the Use of Holding Companies for Cross-Border Dividends and Interest – A New Test to Disentangle Abuse from Real Economic Activity?' (2020) World Tax Journal, issue 1, 15; A. Zalasiński, 'The ECJ's Decisions in the Danish 'Beneficial Ownership' Cases: Impact on the Reaction to Tax Avoidance in the European Union' (2019) International Tax Studies, issue 4, 21; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 240-241.

71 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, 7.

72 *See also* D. Weber, 'The proposed EC Interest and Royalty Directive' (2000) EC Tax Review, issue 1, 23; L. Hinnekens, 'European Commission introduces beneficial ownership in latest tax directives proposals adding to the confusion with regard to its meaning' (2000) EC Tax Review, issue 1, 43.

73 *See also* C. Hamra & J. Korving, 'Beneficial Ownership Interpreted, To What Extent Are the OECD and the EU on the Same Wavelength?' (2021) Intertax, issue 3, 267; P. Arginelli, 'Open Issues in the Application of the Interest and Royalty Directive to Royalty Payments' in G. Maisto (ed.), *Taxation of Intellectual Property under Domestic Law, EU Law and Tax Treaties*, (IBFD 2018), 71-72; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 219.

74 About some final changes regarding the wording of the definition of beneficial owner for companies, *see* J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 220-221 and 240; *see also* C. Hamra & J. Korving, 'Beneficial Ownership Interpreted, To What Extent Are the OECD and the EU on the Same Wavelength?' (2021) Intertax, issue 3, 267-268.

(b) Beneficial ownership and abuse of rights: the connection between "its own benefit" and "not as an intermediary"

Within the above-delineated framework, the concept of "intermediary" defines the category of recipients that do not qualify as beneficial owners under the IRD. This concept is not expressly defined under the Directive.[75] Furthermore, Art. 1(4) – through the expression "such as" – introduces the reference to agent, trustee, or authorized signatory simply as examples of intermediaries. Therefore, Art. 1(4) IRD does not contain an exhaustive list of subjects not qualifying as beneficial owner.[76] Interestingly, in the 2009 report, the Commission also took also into consideration the possibility of amending the definitions[77] of beneficial ownership under the IRD in order to make them "more precise".[78] **13.030**

In Art. 1(4) IRD, the category of intermediaries not qualifying as beneficial owners is interpretively connected with the part of the definition identifying the beneficial owner as the person receiving the payments of interest or royalties "for its own benefit". Therefore, this last requirement positively defines the status of beneficial owner in contrast to the status of intermediary as the *formal* owner.[79] In fact, the actual scope of the beneficial owner's definition (including a more precise delineation of the concept of intermediaries) varies – as will be concretely shown below – depending on the specific interpretation given to the connection between the two relevant components ("for its own benefit" / "and not as an intermediary"). **13.031**

This connection is expressly addressed by the CJEU in the Danish cases on interest. The Court – referring to paragraph 27 of its judgment in the Scheuten Solar Technology GmbH case – pointed out that, in light of the definition of interest under Art. 2(a) IRD as "income from debt-claims of every kind", "only the actual beneficial owner can receive interest which constitutes income from **13.032**

75 *See also* J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 241.

76 *See also* J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 241.

77 It is interesting to note that the report uses the plural ("definitions") referring to Art. 1(4) and Art. 1(5). See below about the relationship between the provisions generally concerning companies and those more specifically concerning permanent establishments.

78 European Commission, 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, COM(2009) 179 final, 4.

79 Danish IRD Cases, para. 89. *See also* E. Kemmeren, 'Preface to Articles 10 to 12' in E. Reimer and A. Rust (eds.), *Klaus Vogel on Double Taxation Conventions* (Kluwer Law International 2022), 843.

such claims".[80] Consequently, the Court identified the beneficial owner under the IRD as "an entity which *actually benefits [emphasis added]* from the interest that is paid to it".[81] It is in light of this interpretation that the Court reached the conclusion according to which "[a]rticle 1(4) of the directive *confirms* that reference to *economic reality [emphasis added]* by stating that a company of a Member State is to be treated as the beneficial owner of interest or royalties *only if it receives those payments for its own benefit and not as an intermediary [emphasis added]*, such as an agent, trustee or authorised signatory, for some other person".[82] Thus, in the interpretation of the CJEU, the concept of intermediary is defined – by exclusion – in connection to a broad economic interpretation of the concept of "own benefit".[83] Also on the basis of the different language versions translating the concept of beneficial owner under Art. 1(1) IRD, the Court concluded that "the term 'beneficial owner' concerns not a *formally identified [emphasis added]* recipient but rather the entity which benefits economically from the interest received and accordingly has the power freely to determine the use to which it is put".[84]

13.033 In light of this broad economic interpretative approach, in the Danish cases on interest, the CJEU has identified the occurrence of beneficial owner status with the absence of an instance of abuse of rights. By addressing some questions of the referring courts concerning the assessment of the beneficial owner status, the CJEU expressly held that these questions, "in essence", concerned the identification of the constituent elements of abuse of rights.[85] Therefore, the Court expressly reconnected the assessment regarding the status of beneficial owner with an investigation on the occurrence of instances of abuse of rights.[86] This is particularly clear when the Court stated: "[a] group of companies may be regarded as being an artificial arrangement where it is not set up for reasons that reflect economic reality, its structure is purely one of form and its principal objective or one of its principal objectives is to obtain a tax advantage running counter to the aim or purpose of the applicable tax law.

80 Danish IRD Cases, para. 87.
81 Danish IRD Cases, para. 88.
82 Danish IRD Cases, para. 88.
83 *See also* C. De Pietro, 'Beneficial Ownership, Tax Abuse and Legal Pluralism: An Analysis in Light of the CJEU's Judgment Concerning the Danish Cases on Interest' (2020) Intertax, issue 12, 1079-1080.
84 Danish IRD Cases, para. 89.
85 Danish IRD Cases, para. 123.
86 *See also* Confédération Fiscale Européenne, 'Opinion Statement ECJ-TF 2/2019 on the ECJ Decisions of 26 February 2019 in N Luxembourg I et al. (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) and T Danmark et al. (Joined Cases C-116/16 and C-117/17), Concerning the "Beneficial Ownership" Requirement and the Anti-Abuse Principle in the Company Tax Directives' (2019) European Taxation, issue 10, 499.

That is so inter alia where, on account of a conduit entity interposed in the structure of the group between the company that pays interest and the entity which is its beneficial owner, payment of the tax on the interest is avoided".[87] Accordingly, the indicia individuated by the CJEU to assess the existence of a conduit company are substantially instrumental to an economic analysis. Thus, for example, relevant elements for the purposes of this assessment are the fact that the company does not actually perform an economic activity, the consequential insignificant profits of the company, and the valuation of its equity.[88]

The interpretative approach of the CJEU in the Danish cases on interest actually reflects the position already expressed by the Commission in the 2009 report. When pointing out, as already indicated above, that the beneficial owner requirement has the specific function of tackling artificial conduit arrangements, the Commission concludes that "[i]t may therefore be doubted whether a company that satisfied the 'beneficial owner' test could be considered an artificial conduit when applying Article 5".[89] **13.034**

Arguably, the interpretative approach of the CJEU, as developed in the Danish cases on interest on the concept of beneficial owner, goes even beyond the position of the OECD. According to paragraph 10.2 of the OECD Commentaries on Article 11,[90] the analysis concerning the occurrence of the status of beneficial owner must focus on the existence of a contractual or legal obligation to pass on the payment received to another person. However, paragraph 10.2 expressly also refers to facts and circumstances. This reference has been considered as creating uncertainty about the possibility that the analysis on the identification of the beneficial owner could be conducted on the basis of a broad approach that takes into consideration facts and circumstances also **13.035**

87 Danish IRD Cases, para. 127.

88 Danish IRD Cases, paras. 128-133.

89 European Commission, 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, COM(2009) 179 final, 8.

90 As far as royalties are concerned, *see* para. 4.3 of the OECD Commentaries on Article 12 of the OECD Model Tax Convention.

beyond the existence of a contractual or legal obligation.[91, 92] However, arguably, in the OECD's position, facts and circumstances can only be instrumental in proving the existence of a contractual or legal obligation to pass on the payment that is received to another person.[93] This is especially clear from the sentence (in paragraph 10.2) according to which facts and circumstances are meant to show that "in substance, the recipient clearly does not have the right to use and enjoy the interest unconstrained by a *contractual or legal obligation* to pass on the payment received to another person *[emphasis added]*". The right to use and enjoy the interest is associated with the absence of a *contractual or legal obligation* to pass on the payment that is received to another person.[94]

13.036 In the Danish cases on interest, the referring courts – by expressly mentioning the 2014[95] OECD Commentaries – specifically asked whether the recipient of interest should be denied the qualification as beneficial owner under the IRD when, in the absence of a contractual or legal obligation to pass on the interest,

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91 E. Kemmeren, 'Preface to Articles 10 to 12' in E. Reimer and A. Rust (eds.), *Klaus Vogel on Double Taxation Conventions* (Kluwer Law International 2022), 837; F. Vallada, 'Beneficial Ownership under Articles 10,11 and 12 of the 2014 OECD Model Convention' in M. Lang et al (eds), *The OECD-Model-Convention and its Update 2014. Series on International Tax Law, Volume 90* (IBFD / Linde 2015), 45. With reference to the 2011 OECD Discussion Draft on the clarification of the meaning of "beneficial owner", *see* D. S. Smit, 'The Concept of Beneficial Ownership and Possible Alternative Remedies in Netherlands Case Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 68; D. Gutmann, 'The 2011 Discussion Draft on Beneficial Ownership: What Next for the OECD?' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends*, (IBFD 2013), 343.

92 Through the years, in literature and case law, different positions have been maintained, analyzing the occurrence of the status of beneficial owner (1) strictly on the basis of the law, (2) in law, through the evaluation of facts, or (3) both on the basis of law and/or facts. *See* E. Kemmeren, 'Preface to Articles 10 to 12' in E. Reimer and A. Rust (eds.), *Klaus Vogel on Double Taxation Conventions* (Kluwer Law International 2022), 836; R. J. Danon, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups' (2018) Bulletin for International Taxation, issue 1, 32-35; A. M. Jiménez, 'Beneficial Ownership: Current Trends' (2010) World Tax Journal, issue 1, 35 ss.; L. De Broe, *International Tax Planning and Prevention of Abuse. A Study under Domestic Tax Law, Tax Treaties and EC law in Relation to Conduit and Base Companies* (IBFD 2008), 686 ss.; K. Vogel at al., *The OECD Model Convention - 1998 and beyond; The concept of beneficial ownership in tax treaties (proceedings of a seminar held in London in 1998 during the 52nd Congress of the International Fiscal Association)* (Kluwer 1998), 22-25; S. van Weeghel, *The Improper Use of Tax Treaties. With Particular Reference to the Netherlands and the United States* (Kluwer Law International 1998), 77.

93 E. Kemmeren, 'Preface to Articles 10 to 12' in E. Reimer and A. Rust (eds.), *Klaus Vogel on Double Taxation Conventions* (Kluwer Law International 2022), 837-838; R. J. Danon, 'Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups' (2018) Bulletin for International Taxation, issue 1, 35; F. Vallada, 'Beneficial Ownership under Articles 10,11 and 12 of the 2014 OECD Model Convention' in M. Lang et al (eds), *The OECD-Model-Convention and its Update 2014. Series on International Tax Law, Volume 90* (IBFD / Linde 2015), 45.

94 *See also* C. De Pietro, 'Beneficial Ownership, Tax Abuse and Legal Pluralism: An Analysis in Light of the CJEU's Judgment Concerning the Danish Cases on Interest' (2020) Intertax, issue 12, 1077-1079.

95 When the above-mentioned para. 10.2 was added.

"in substance"[96] this recipient does not the right to use and enjoy the interest. The CJEU stated on this point that the indicia relevant for the assessment of the qualification as beneficial owner "are capable of being constituted not only by a contractual or legal obligation of the company receiving interest to pass it on to a third party but also by the fact that, '*in substance*', as the referring court states in Cases C-115/16, C-118/16 and C-119/16, that company, *without being bound by such a contractual or legal obligation [emphasis added]*, does not have the right to use and enjoy those sums".[97] In fact, the CJEU takes into consideration facts and circumstances also beyond the existence of a contractual or legal obligation.

Thus, on the basis of the analysis conducted above, it can be concluded that the CJEU founded the assessment of the status of beneficial owner on a broad economic interpretative approach. As a consequence of this approach, in the interpretation of the Court, the concept of "own benefit" is the core element when assessing the status of beneficial owner, while the concept of "intermediary" is residually (by exclusion) determined as any subject that is artificially interposed between the payer and the person economically benefiting from the payment. **13.037**

Interestingly, this broad economic approach of the CJEU does not reflect the position expressed by Advocate General Kokott in her Opinions in the Danish cases on interest,[98] where she identified the beneficial owner with the person entitled under civil law to claim the payment.[99] Both the CJEU and the Advocate General had the same starting point – paragraph 27 of the Scheuten Solar Technology GmbH judgment – but they reached different conclusions. Advocate General Kokott identified the "actual" beneficial owner referred to in the Scheuten Solar Technology GmbH judgment with the person holding the right under civil law to claim the payment in its own name and on its own account (i.e., for its own benefit). The Advocate General argued for the possibility (of the referring courts) to interpret the circumstances of each case **13.038**

96 Danish IRD Cases, para. 45, question (1)(f), para. 57, question (1)(f), para. 63, question (1)(f), para. 79, question (1)(e).

97 Danish IRD Cases, para. 132.

98 Opinion of Advocate General Kokott 1 March 2018, Case C-115/16 N Luxembourg 1 ECLI:EU:C:2018:143, paras. 35-47. *See also*, Opinion of Advocate General Kokott 1 March 2018, Case C-118/16 X Denmark A/S v Skatteministeriet, ECLI:EU:C:2018:146, paras. 35-47; Opinion of Advocate General Kokott 1 March 2018, Case C-119/16, C Danmark I v Skatteministeriet, ECLI:EU:C:2018:147, paras. 35-47; Opinion of Advocate General Kokott 1 March 2018, Case C-299/16, Z Denmark v Skatteministeriet, ECLI:EU:C:2018:148, para. 35-47.

99 *See also* L. De Broe and S. Gommers, 'Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases' (2019) EC Tax Review, issue 6, 291-292.

in order to verify the existence of a "hidden trust"[100] relationship. However, when developing some "useful pointers"[101] that the CJEU could provide to the referring courts, she limited the interpretation of relevant circumstances to the proof of the existence of a specific juridical relationship (i.e., a trust relationship).[102] Therefore, the position of Advocate General Kokott actually seems to reflect the stance of the OECD as expressed in paragraph 10.2 of the OECD Commentaries on Art. 11, which, as indicated above, arguably attributes a more limited scope to the concept of beneficial owner compared to the broad economic approach of the CJEU in the Danish cases on interest.

13.039 In conclusion, while according to Advocate General Kokott, in line with the position of the OECD, the assessment concerning the status of beneficial owner is limited to the proof of the existence under civil law of a juridical relationship qualifying the recipient as a mere intermediary, in light of the position of the CJEU, the exclusion of the status of intermediary derives from the interpretation of "own benefit" in broad economic terms (and, therefore, also beyond the existence of a qualified juridical relationship). The comparison between the position of the CJEU and that of the Advocate General in the Danish cases on interest concretely shows how the scope of the concept of beneficial owner under the IRD may actually vary depending on the accepted interpretative approach to the relationship between the two components ("for its own benefit" / "and not as an intermediary") characterizing the definition of beneficial owner under Art. 1(4) of the IRD. In fact, according to the position of the Advocate General Kokott, and contrary to the position of the CJEU as shown above, the concept of intermediary on the basis of a qualified juridical relationship becomes central to exclude the status of beneficial owner, with the consequence that, in this case, it is the concept of "own benefit" (in its own name and on its own account) that derives from the notion of intermediary.

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100 Opinion of Advocate General Kokott 1 March 2018, Case C-115/16, N Luxembourg 1, ECLI:EU:C:2018:143, para. 42. *See also*, Opinion of Advocate General Kokott 1 March 2018, Case C-118/16, X Denmark A/S v Skatteministeriet, ECLI:EU:C:2018:146, para. 42; Opinion of Advocate General Kokott 1 March 2018, Case C-119/16, C Danmark I v Skatteministeriet, ECLI:EU:C:2018:147, para. 42; Opinion of Advocate General Kokott 1 March 2018, Case C-299/16, Z Denmark v Skatteministeriet, ECLI:EU:C:2018:148, para. 42.

101 Opinion of Advocate General Kokott 1 March 2018, Case C-115/16, N Luxembourg 1, ECLI:EU:C:2018:143, para. 42. See also, Opinion of Advocate General Kokott 1 March 2018, Case C-118/16, X Denmark A/S v Skatteministeriet, ECLI:EU:C:2018:146, para. 42; Opinion of Advocate General Kokott 1 March 2018, Case C-119/16, C Danmark I v Skatteministeriet, ECLI:EU:C:2018:147, para. 42; Opinion of Advocate General Kokott 1 March 2018, Case C-299/16, Z Denmark v Skatteministeriet, ECLI:EU:C:2018:148, para. 42.

102 *See also* I. Lazarov, '(Un)Tangling Tax Avoidance Under the Interest and Royalties Directive: the Opinion of AG Kokott in N Luxembourg 1' (2018) Intertax, issue 11, 875-876.

In literature, an economic interpretative approach, although with differently nuanced positions, prevails when interpreting the concept of beneficial owner under the IRD.[103] De Broe and Gommers maintain that, in fact, arguments can be advanced both in favor of a more economic approach as well as in favor of a more legal one.[104] **13.040**

4. THE DEFINITION OF BENEFICIAL OWNER UNDER ART. 1(5) IRD AND ITS INTERPRETATION

As far as permanent establishments are concerned, Art. 1(5) of the IRD specifically indicates two criteria to which their qualification as beneficial owners is conditioned: under letter (a) the debt-claim, right or use of information in respect of which interest or royalty payments arise must be effectively connected with the permanent establishment ("effective connection" test); and, under letter (b) the interest or royalty payments must represent income in respect of which the permanent establishment is subject in the Member State in which it is situated to one of the taxes mentioned in Article 3(a)(iii) or to a tax which is identical or substantially similar and which is imposed after the date of entry into force of the IRD in addition to, or in place of, those existing taxes ("subject-to-tax" test). **13.041**

The 1998 IRD proposal did not distinguish between the beneficial ownership requirements for companies and permanent establishments. As already indicated above, Art. 3(1)(c) stated that "the 'beneficial owner' of payments of interest or royalties is a company of a Member State or a permanent establishment which holds those payments for its own benefit and not as an agent, trustee or nominee for some other person". The fact that the adopted Directive has distinguished between the position of companies and permanent establishments raises the question of whether Articles 1(4) and 1(5) actually indicate two distinct definitions.[105] **13.042**

103 C. Hamra & J. Korving, 'Beneficial Ownership Interpreted, To What Extent Are the OECD and the EU on the Same Wavelength?' (2021) Intertax, issue 3, 267; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 242; S. Fernandes e.a., 'A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 1' (2011) European Taxation, issue 9-10, 404; M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, 148.

104 L. De Broe and S. Gommers, 'Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases' (2019) EC Tax Review, issue 6, 289.

105 *See also* footnote n. 77 above with reference to the wording of the 2009 report.

13.043 As far as the "effective connection" test is concerned, in literature there is convergence at least on the possible reason explaining the adoption of specific criteria applicable to permanent establishments. In fact, the separate entity approach requires defining the criteria specifically allocating the income to a permanent establishment,[106] and, consequently, to the tax jurisdiction where it is situated.[107] This interpretative approach is coherent with both Art. 1(6) IRD establishing that, when the permanent establishment qualifies as payer or beneficial owner, the same qualification cannot be attributed to any other part of the company with respect to the same payment of interest or royalties,[108] and with Art. 1(9) IRD, which expressly recognizes the taxing right of the Member State where the permanent establishment is situated.[109] Thus, some authors specifically conceive the "effective connection" test as a "genuine economic link"[110] between the debt-claim, right or use of information in respect of which the payment arises and the permanent establishment.

13.044 Different positions have been advanced on the relationship between the definitions under Art. 1(4) and Art. 1(5) of the IRD. According to some authors, the requirements for permanent establishments under Art. 1(5) can arguably be considered additional to those generally established for companies under Art. 1(4). Therefore, in order for a permanent establishment to qualify as a beneficial owner, in the first instance the relevant company must qualify as such under Art. 1(4).[111] It is also argued that the "effective connection" test under Art. 1(5) actually coincides with the "own benefit" concept under Art.

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106 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 509-510; L. De Broe and S. Gommers, 'Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases' (2019) EC Tax Review, issue 6, 288; S. Fernandes e.a., 'A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 1' (2011) European Taxation, issue 9-10, 404; M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, 149; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 246.

107 J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 247.

108 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 510; D. Hristov, 'Chapter 7 – The Interest and Royalties Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde 2020), 209; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 246.

109 D. Hristov, 'Chapter 7 – The Interest and Royalties Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde 2020), 208.

110 M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, issue 4, 149. *See also* D. Hristov, 'Chapter 7 – The Interest and Royalties Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde 2020), 209.

111 M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 1' (2005) European Taxation, issue 2, p. 42; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 245.

1(4).[112] Finally, it is also stated that Art. 1(4) and Art. 1(5) simply indicate different requirements for companies and permanent establishments to qualify as beneficial owner.[113]

It has also been suggested that the "effective connection" test should be based on the OECD position. In fact, the term "effectively connected" used in Art. 1(5) is the same term used respectively in Articles 11(4) and 12(3) of the OECD Model Tax Convention.[114] **13.045**

Art. 1(5)(b) establishes, as a second condition for a permanent establishment to qualify as beneficial owner, a "subject-to-tax" test. It requires that the interest or royalty payments attributed to the permanent establishment are subject to tax in the Member State where the permanent establishment is situated. More specifically, the relevant taxes are those mentioned in Article 3(a)(iii) or a tax which is identical or substantially similar and which is imposed after the date of entry into force of the IRD in addition to, or in place of, those existing taxes. Thus, the "subject-to-tax" test under Art. 1(5)(b) is generally[115] considered to be of an objective nature as it concerns the effective taxation of the relevant income.[116] It has also been argued that effectiveness should not be conceived in a narrow sense and that, therefore, the status of beneficial owner should not be denied when interest or royalties are objectively taxed, although **13.046**

112 S. Fernandes e.a., 'A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 1' (2011) European Taxation, issue 9-10, 404; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 245.

113 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 510; D. Hristov, 'Chapter 7 – The Interest and Royalties Directive' in M. Lang et al (eds), *Introduction to European Tax Law on Direct Taxation* (Linde 2020), 209; M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, issue 4, 149.

114 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 510; S. Fernandes e.a., 'A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 1' (2011) European Taxation, issue 9-10, 404.

115 For a different position, *see* P. Arginelli, 'Open Issues in the Application of the Interest and Royalty Directive to Royalty Payments' in G. Maisto (ed.), *Taxation of Intellectual Property under Domestic Law, EU Law and Tax Treaties*, (IBFD 2018), 66. *See also* J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 246.

116 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 499; Confédération Fiscale Européenne, 'Opinion Statement ECJ-TF 2/2019 on the ECJ Decisions of 26 February 2019 in N Luxembourg I et al. (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) and T Danmark et al. (Joined Cases C-116/16 and C-117/17), Concerning the "Beneficial Ownership" Requirement and the Anti-Abuse Principle in the Company Tax Directives' (2019) European Taxation, issue 10, 501-502; M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, issue 4, 149; D. Weber, 'The proposed EC Interest and Royalty Directive' (2000) EC Tax Review, issue 1, 21; S. Fernandes e.a., 'A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 1' (2011) European Taxation, issue 9-10, 404.

not specifically taxed under some circumstances like "loss carry-forwards, credits or deductions".[117]

13.047 The objective nature of the "subject-to-tax" test under Art. 1(5)(b) has posed a significant interpretative issue concerning its relationship with Art. 3(a)(iii). In fact, this last provision textually requires the subject of taxation (a company of a Member State) to be taxed, without being exempt, and not the object of taxation (interest or royalty payments), as in the case of Art. 1(5)(b).[118, 119] This difference between the two "subject-to-tax" tests under the IRD is also expressly pointed out by the Commission in the 2009 report[120] and has led several authors to highlight an unjustifiable different treatment,[121] possibly breaching the freedom of establishment,[122] between companies and permanent establishments, as companies would benefit from the IRD when they are subject to tax regardless of effective taxation of the relevant interest or royalty. Thus, in 2003[123] and 2011[124] the Commission proposed the introduction of an effective "subject-to-tax" clause in Art. 1(1) of the IRD, expressly covering both companies and permanent establishments. These proposals have not

117 G. Kofler, 'Chapter 3 Open Issues in the Application of the EU Interest-Royalties Directive' in G. Maisto (ed), *Taxation of Interest under Domestic Law, EU Law and Tax Treaties* (IBFD 2022), 76 and, more specifically, footnote no. 103; Confédération Fiscale Européenne, 'Opinion Statement ECJ-TF 2/2019 on the ECJ Decisions of 26 February 2019 in N Luxembourg I et al. (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) and T Danmark et al. (Joined Cases C-116/16 and C-117/17), Concerning the "Beneficial Ownership" Requirement and the Anti-Abuse Principle in the Company Tax Directives' (2019) European Taxation, issue 10, 502; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 225.

118 S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 499; J. López Rodriguez and G. Kofler, 'Chapter 16 Beneficial Ownership and EU Law' in M. Lang et al (eds), *Beneficial Ownership: Recent Trends* (IBFD 2013), 223.

119 However, according to Weber, Art. 3(a)(iii) should be interpreted as having an objective nature in order to guarantee the same treatment to companies and permanent establishments, in accordance with the *Saint-Gobain* case (C-307/97). *See* D. Weber, 'The proposed EC Interest and Royalty Directive' (2000) EC Tax Review, issue 1, 21.

120 European Commission, 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, COM(2009) 179 final, pp. 3-4.

121 M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, issue 4, 149. *See also* P. Arginelli, 'Open Issues in the Application of the Interest and Royalty Directive to Royalty Payments' in G. Maisto (ed.), *Taxation of Intellectual Property under Domestic Law, EU Law and Tax Treaties*, (IBFD 2018), 65.

122 S. Fernandes e.a., 'A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 1' (2011) European Taxation, issue 9-10, 406.

123 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(2003) 841 final (30 Dec. 2003).

124 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(2011) 714 final (11 Nov. 2011).

been adopted. However, in the Danish cases on interest, the CJEU, exactly on the basis of the objective nature of the "subject-to-tax" test under Art. 1(5)(b) as well as the need to assure taxation at least once in a Member State, has argued that – under Art. 3(a)(iii) – a company receiving interest payments not effectively subjected to tax in the relevant Member State does not qualify as a "company of a Member State" and, therefore, cannot benefit from the IRD regime.[125] Thus, in fact, the CJEU has interpretatively aligned Art. 1(5)(b) and Art. 3(a)(iii).[126]

125 Danish IRD Cases, paras. 150-153.

126 *See also* S. Douma et al (eds), *Terra/Wattel European Tax Law* (Vol. I, Wolters Kluwer 2022), 506; Confédération Fiscale Européenne, 'Opinion Statement ECJ-TF 2/2019 on the ECJ Decisions of 26 February 2019 in N Luxembourg I et al. (Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16) and T Danmark et al. (Joined Cases C-116/16 and C-117/17), Concerning the "Beneficial Ownership" Requirement and the Anti-Abuse Principle in the Company Tax Directives' (2019) European Taxation, issue 10, 493.

14

ARTICLE 2: DEFINITION OF INTEREST AND ROYALTIES

Filip Debelva

For the purposes of this Directive:

(a) **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, and in particular, income from securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payment shall not be regarded as interest;**

(b) **the term 'royalties' means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films and software, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; payments for the use of, or the right to use, industrial, commercial or scientific equipment shall be regarded as royalties.**

COMMENTARY

Article 2 of the IRD has received relatively little scholarly attention, despite its crucial role in defining the objective scope of the directive. The following sections will first examine the definition of "interest" (A.), followed by the notion of "royalty" (B.). **14.001**

A. The definition of "interest" in Article 2(a)

The definition of interest under the IRD has evolved over time through a series of successive proposals and legislative amendments. While many of these modifications may appear to be technical in nature, they play a crucial role in shaping the interpretation and practical application of this article. **14.002**

1. The original proposal (1990)

In the original Commission proposal that was presented on 28 November 1990,[1] but which was later withdrawn, the definition of interest was notably more restrictive than the one currently in force. It was formulated as follows: "income from debt-claims of every kind, whether or not carrying a right to participate in the debtor's profits, including premiums and prizes attaching to bonds or debentures." This formulation was quite concise (especially when compared to the present-day text) and seemed to focus primarily on conventional debt instruments. However, the accompanying commentary provided further clarification regarding the intended breadth of the term "debt-claims of every kind." Specifically, it stated that this concept also encompassed "cash deposits and security in the form of money".[2] An identical description can be found in the OECD Commentary on Article 11.[3] **14.003**

Moreover, the adjoining explanatory memorandum explicitly linked this definition in the IRD to Article 11 of the 1977 OECD Model Convention,[4] dealing with the division of tax jurisdiction regarding interest income in a tax treaty context. Therefore, the connection to international tax law standards seemed evident at this stage, as this would allow the European legislator to benefit **14.004**

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1 Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States (COM (90) 571 final), OJ C 53, 28.2.1991, 26–29. *See* for an analysis of this proposal: O. Thömnes, "The new EC Commission's proposals for directives on cross-border investments", (1991) *Intertax*, issue 3, 158-165.

2 EU Commission (1991), Removal of tax obstacles to the cross-frontier activities of companies, Bulletin of the European Communities, Supplement 4/91, 52

3 OECD Commentary on Article 11, para. 18.

4 EU Commission (1991), Removal of tax obstacles to the cross-frontier activities of companies, Bulletin of the European Communities, Supplement 4/91, 52

from the practical experience already gained when applying the same term in bilateral relationships.[5] This cross-reference is significant, as it suggests that the drafters of the IRD sought to align its scope with preexisting tax treaty principles, thereby facilitating consistency in the treatment of interest across these legal frameworks. Nevertheless, it is remarkable that despite the intended alignment with Article 11(3) of the 1977 OECD Model Convention, both provisions differed in several ways:[6]

- Article 11(3) of the 1977 OECD Model Convention *specified* that it is irrelevant whether or not the debt-claim was secured by a mortgage or not;
- Article 11(3) of the 1977 OECD Model Convention *included* income from government securities;
- Article 11(3) of the 1977 OECD Model Convention *excluded* penalty charges for late payment from the scope of the article.

14.005 The present-day text is aligned more closely with the definition as included in the OECD Model Convention, with the exception of the different treatment of government securities (see *infra,* A.3.).

14.006 A particularly interesting aspect of the commentary concerns the treatment of profit-participating loans, which represent hybrid financial instruments that demonstrate characteristics of both debt and equity.[7] According to the commentary, such instruments fall within the scope of the directive "insofar as the contract by its general character clearly evidences a loan at interest." This clarification, which was again borrowed from the OECD Commentary on Article 11,[8] highlights the underlying economic substance approach in this context. Rather than relying solely on formal legal classifications of the debt instrument at hand, the directive appears to take into account the economic reality of financial instruments, ensuring that loans with an interest-bearing character remain within the directive's scope, even if they contain equity-like features. Note, however, that in order to correctly apply the directive to these

5 O. Thömnes, 'The new EC Commission's proposals for directives on cross-border investments', (1991) *Intertax*, issue 3, 160.

6 Article 11(3) of the 1977 OECD Model Convention: "The term 'interest' as used in this Article 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, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."

7 EU Commission (1991), Removal of tax obstacles to the cross-frontier activities of companies, Bulletin of the European Communities, Supplement 4/91, 52

8 OECD Commentary on Article 11, para. 18.

instruments, this provision should be read together with Article 4 of the directive (see *infra* Article 4).

In an effort to refine and broaden the scope of the proposed directive, the European Commission adopted an amendment to this first proposal on 10 June 1993. This amendment, requested by the Parliament,[9] introduced a second paragraph to Article 2.[10] The text of the proposed addition read as follows: "In addition to the provisions in paragraph 1, all other payments regarded as interest or royalty payments, either under a Double Taxation Convention in force between the Member State of the debtor and the Member State of the recipient or, in the absence of such a convention, by the tax laws of the Member State of the debtor, shall be treated as such for the purposes of this Directive." **14.007**

The intention behind this amendment, as clarified in the accompanying commentaries, was to ensure that the directive would fully encompass all payments that are classified as interest or royalty payments under either bilateral tax treaties or domestic tax laws. By incorporating this provision, the Commission sought to align the IRD's scope with the bilateral treaties already established by Member States, thereby preventing discrepancies in the qualification of payments. Despite its clear intent, the amendment could in our opinion raise questions regarding potential conflicts between national interpretations and EU law. Since Member States have different approaches to classifying payments, even under tax treaties, as evidenced by a number of reservations to the relevant paragraphs in the OECD Commentaries, the proposal could have led to situations where a similar payment is treated as interest (or a royalty) in one jurisdiction but not in another, thereby undermining the goal of the directive (i.e., to achieve a harmonized tax treatment of cross-border interest payments). **14.008**

2. The second proposal (1998)

(a) General

On 4 March 1998, a second proposal was published by the Commission,[11] which expanded the existing wording of the "interest" definition. This revised **14.009**

9 Legislative resolution embodying the opinion of the European Parliament on the proposal from the Commission to the Council for a directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, OJ C 67, 16.3.1992, 195.

10 Amended proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States (COM(93) 196 final), OJ C 178, 30.6.1993, 18.

11 *See* for an analysis of this proposal: J.D.B. Oliver, 'The Proposed EU Interest and Royalties Directive', (1991) *Intertax* issue 6-7, 204-206; D. Weber, 'The proposed EC Interest and Royalty Directive', (2001)

definition sought to provide greater clarity and precision by explicitly addressing certain ambiguities present in the earlier version. To illustrate the evolution of the wording, the text of the 1998 proposal is compared below to the text of the 1990 proposal.

1990 Proposal	1998 Proposal
"interest" means income from debt-claims of every kind, whether or not carrying a right to participate in the debtor's profits, including premiums and prizes attaching to bonds or debentures.	"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, ***and in particular, income from bonds or debentures***, including premiums and prizes attaching to such bonds or debentures. ***Penalty charges for late payment shall not be regarded as interest.***

14.010 The 1998 revision introduced several notable changes to the definition. First, it explicitly extended the scope of debt-claims to include those secured by mortgage, which was not mentioned in the 1990 version. This addition clarified that the directive also applies to interest payments arising from secured loans, in line with Article 11(3) of the OECD definition (*supra*, A.1). We submit that this change is not essential as such (as the text indicates that the question whether or not the underlying debt is secured is irrelevant for the application of the Directive), but in doing so, the text more closely resembles the OECD definition. According to the Commission's adjoining commentary, the definition that was included in the proposed directive was indeed based on the one used in Article 11 of the 1996 OECD Model Tax Convention.[12] The reasoning behind the explicit mention of mortgage-backed loans lies in the fact that certain countries assimilate mortgage interest to *immovable* property[13] rather than income from *movable* capital.[14]

EC Tax Review, issue 1, 15-30.

12 Article 11(3) of the 1996 OECD Model Convention: "The term "interest" as used in this Article 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, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."

13 OECD Commentary on Article 11, para. 18. *See* also J. López Rodriguez, 'Commentary on the Interest and Royalties Directive' in O. Thömmes and E. Fuks (eds), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD 2008), no. 110.

14 This can be compared to the approach taken regarding "mineral royalties" under Article 2(b) of the 1998 IRD proposal (see *infra*, B.2).

Second, while the 1990 proposal explicitly included premiums and prizes *attaching to bonds or debentures*, the 1998 proposal reinforced this aspect by rephrasing the provision to read: "income from bonds or debentures, including premiums and prizes attaching to such bonds or debentures." Although no specific justification was provided for this modification, it is reasonable to assume that the change was once more influenced by a desire to align more closely with the OECD's definition of interest, which similarly encompasses a broad range of income derived from debt instruments. From a purely textual perspective, it could be argued that the revised wording taken in isolation results in a broader definition. The original formulation ("premiums and prizes attaching to bonds or debentures") could be interpreted as referring exclusively to one-off income, such as lottery bond winnings ("premium bonds") or redemption premiums granted upon early repayment of debt. This phrasing might give the impression that it does not necessarily include the regular interest income typically generated by bonds and debentures, such as periodic coupon payments. By contrast, the revised wording ("income from bonds or debentures, including premiums and prizes attaching to such bonds or debentures") appears to clarify that the entire income stream from these financial instruments is covered, encompassing not only lump-sum payments but also recurring interest payments. Nevertheless, it is debatable whether the change has any real practical significance. The first sentence of the interest definition already refers to income from debt-claims of every kind, which naturally includes all forms of interest-related income, such as coupon payments, redemption premiums, and other forms of remuneration associated with these instruments. Given that all these income types were already covered under the broader category of income from debt-claims, the revised wording may be largely redundant. **14.011**

Third, and perhaps most significant, the 1998 proposal explicitly excluded penalty charges for late payment from the definition of interest, again aligning more closely with the OECD's definition of interest. This exclusion was a noteworthy refinement, as it clarified the distinction between genuine income from capital and compensatory payments arising from delayed obligations. The need for this clarification was likely driven by the risk for differing classifications of these charges under national tax laws. In some jurisdictions, such payments might have been considered a form of interest, whereas in others, they could have been treated as damages or compensatory payments rather than income from debt-claims. The accompanying commentary to the 1998 proposal further elaborated on this rationale, providing the following justification: "Penalty charges for late payment do not really constitute income **14.012** from capital, but are rather a special form of compensation for loss suffered through the debtor's delay in meeting his obligations. These charges are therefore, as in Article 11 of the OECD Model Tax Convention, not regarded as interest for the purposes of this Directive." This explanation underscores the economic distinction between interest (which represents compensation for the use of capital) and late payment penalties (which function as reparations for a breach of contractual obligations).

14.013 Aside from these textual changes to the interest definition between both proposals, the 1998 proposal also provides more guidance on several aspects:

- As mentioned above, and as opposed to the OECD definition, interest in the directive does not include "income from government securities". According the commentary on Article 2, this income "is not relevant to this Directive".
- The proposal also provided for the Commission to report on the operation of this Directive on the basis of the experience of its operation over the first three years, with a view to an extension of its scope: "The question of reviewing the definition of interest and royalties in light of the convergence of the provisions dealing with interest and royalties in national legislation and in bilateral double taxation treaties may also be considered at that stage." Similar wording was later included in preamble 9 of the current IRD.[15]
- In the report on the proposal that was issued by the Committee on Economic and Monetary Affairs and Industrial Policy on 3 September 1998, it was emphasized that the enumeration of debt instruments in the first paragraph of Article 2 is non-exhaustive, which was concluded on the basis of the wording of the provision, i.e., "income from debt claims of any kind" and "in particular".[16]

(b) Reference to tax treaties and domestic law

14.014 A second paragraph was included in Article 2, further broadening the scope of the definition of interest: "The Directive applies not only to the payments of interest or royalties as defined under paragraph 1 but also to all payments regarded by Member States as such, either under a Double Taxation Convention in force between the Member State where the interest or royalties arise and the Member State of the beneficial owner or, in the absence of such a Convention, on the basis of the national tax legislation of the Member State

15 "It is necessary for the Commission to report to the Council on the operation of the Directive three years after the date by which it must be transposed, in particular with a view to extending its coverage to other companies or undertakings and reviewing the scope of the definition of interest and royalties in pursuance of the necessary convergence of the provisions dealing with interest and royalties in national legislation and in bilateral or multilateral double-taxation treaties."

16 Committee on Economic and Monetary Affairs and Industrial Policy, Report on the 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(98)0067 - C4-0195/98 - 98/0087(CNS)), 12.

where the interest or royalties arise. This extends to payments made by or to a permanent establishment which would be considered to be interest or royalties if they had been made by or to a company in the Member States concerned".

This amendment significantly expanded the objective scope of the directive by ensuring that the definition of interest (and royalties) was not strictly limited to the wording of the first paragraph but could also encompass payments that Member States classify as such under their bilateral tax treaties or, in the absence of such treaties, under their domestic tax legislation. By incorporating this provision, the directive sought to align its application with the existing legal frameworks at both the international and national levels. The inclusion of this second paragraph seems to be based on the recommendation[17] made by the European Parliament[18] during its review of the first proposal, which was accepted on 10 June 1993 (see *supra*, A.1). The legal consequences of not including this paragraph in the adopted text are discussed later (see *infra*, A.3). **14.015**

The revised second paragraph also extends the scope of the provision to include payments made by or to a permanent establishment (PE), reaffirming that such transactions fall within the ambit of the directive. This inclusion reflects the general principle that PEs are typically covered by the directive, ensuring that cross-border payments involving PEs receive the same treatment as those involving corporate entities based in different Member States. However, it could be argued that this addition was not required. Any ambiguity regarding the personal scope of the directive is already (and more appropriately) addressed in Article 3 IRD, which defines the eligible entities and conditions for the directive's application. Therefore, the explicit reference to PEs in Article 2 may not have been strictly necessary. This likely explains why this sentence was not included in the current text of Article 2 (see *infra*, A.3). **14.016**

3. The current text

(a) General

The current text of Article 2 remains largely unchanged from the version adopted in the 1998 proposal. The only notable difference is that the **14.017**

17 "In addition to the provisions in paragraph 1, all other payments regarded as interest or royalty payments, either under a double taxation convention in force between the Member State of the debtor and the Member State of the recipient or, in the absence of such a convention, by the tax laws of the Member State of the debtor, shall be treated as such for the purposes of this Directive."

18 Legislative resolution embodying the opinion of the European Parliament on the proposal from the Commission to the Council for a directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, OJ C 67, 16.3.1992, 195.

exemplative list of financial instruments covered by the directive has been expanded to explicitly include securities, in addition to the previously mentioned bonds and debentures.

1998 Proposal	Current text
"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, and in particular, income from bonds or debentures, including premiums and prizes attaching to such bonds or debentures. Penalty charges for late payment shall not be regarded as interest.	"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, and in particular, income from ***securities and*** income from bonds or debentures, including premiums and prizes attaching to such ***securities***, bonds or debentures; penalty charges for late payment shall not be regarded as interest;

14.018 At first glance, the explicit addition of securities in the current text might suggest an expansion of the directive's scope. The term "securities" is a broad category of financial instruments encompassing various instruments, including equity securities (e.g., shares), debt securities (e.g., bonds and debentures), and even derivative instruments. By contrast, bonds and debentures represent a much narrower subset within the category of debt securities. Given that the directive already explicitly applies to "income from debt-claims of every kind [. . .] whether or not carrying a right to participate in the debtor's profits", one could argue that securities in a broad sense (i.e., both debt and equity-linked instruments) were already covered. The addition of securities does not necessarily change the directive's objective scope unless it is interpreted as including forms of income beyond traditional debt instruments.

(b) Payments that are covered

14.019 There is consensus among scholars that the scope of the IRD should be interpreted broadly.[19] Such an interpretation is further supported by the 1998 report of the Committee on Economic and Monetary Affairs and Industrial Policy, which explicitly noted that the enumeration of debt instruments in Article 2 of the directive should be considered non-exhaustive. Since the text of the 1998 proposal has remained substantively unchanged in the current version of the directive, this conclusion remains valid today. The basis for this interpretation lies in the wording of the provision itself, particularly the use

19 *See* among others L. Cerioni, 'Intra-EC Interest and Royalties Tax Treatment', (2004) *European Taxation*, issue 1, 28; E. Eberhartinger and M. Six, 'Taxation of Cross-Border Hybrid Finance: A Legal Analysis', (2009) *Intertax*, issue 1, 15.

of the phrases "income from debt claims of any kind" and "in particular".[20] These expressions indeed indicate that the listed financial instruments serve merely as examples rather than as an exhaustive or restrictive definition. This expansive interpretation stems from the autonomous nature of the directive's definition of interest, which operates independently of national legal classifications and ensures uniform application across all EU Member States (see also below). Moreover, it is evident that the directive adopts a substance-over-form approach when determining whether a financial instrument qualifies as interest under its provisions.[21] Rather than relying solely on the title or legal classification assigned to a financial arrangement under national law (such as bond, loan, certificate, etc.),[22] the directive focuses on the economic substance of the agreement. This means that payments characterized as something other than interest under national legislation (such as "remuneration" or "fees") could still fall within the directive's scope if, in substance, they function as returns on a debt claim.[23]

The present wording of the provision continues to bear a strong resemblance to the definition of interest used in Article 11 of the OECD Model Tax Convention.[24] This close alignment is hardly surprising, given the explicit references to the OECD Model Tax Convention throughout the legislative history of the directive (*supra*, A.1 and A.2). At one stage in the drafting process, the directive even explicitly referred back to the definition of *interest* as set out in tax treaties (see *supra*, A.2). **14.020**

20 Committee on Economic and Monetary Affairs and Industrial Policy, Report on the 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(98)0067 - C4-0195/98 - 98/0087(CNS)), 12.

21 *Similarly*: OECD Commentary on Article 11, para. 21.1.

22 One author therefore comes to the conclusion that any debt claim that qualifies as a debt claim under private law falls within the directive's scope (J. Bundgaard, 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1', (2010) *European Taxation*, issue 10, 444).

23 J. López Rodriguez, 'Commentary on the Interest and Royalties Directive' in O. Thömmes and E. Fuks (eds), EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation (IBFD 2008), no. 109.

24 K. Eicker and F. Aramini, 'Overview on the recent developments of the EC Directive on Withholding Taxes on Royalty and Interest Payments', (2004) *EC Tax Review*, issue 3, 143; M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot?' – Part 2', (2005) *European Taxation*, issue 2, 44; J. Bundgaard, 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1', (2010) *European Taxation*, issue 10, 444.

14.021 Based on this broad definition,[25] its link with the OECD definition and the legislative process leading up to the present-day text, it can be concluded that the directive's interpretation of "interest" encompasses a wide range of payments, irrespective of their structure or method of calculation. As long as the contract by its general character clearly evidences a loan, the income is covered.[26] This includes interest payments at both fixed and variable rates, where interest fluctuates based on external benchmarks. Additionally, the definition extends to cash deposits and security provided in the form of money.[27] Furthermore, the directive does not impose any restrictions on the form of payment, meaning that both periodic payments (e.g., coupon payments on bonds or debentures) and one-off payments (e.g., income from zero coupon bonds,[28] lottery bond winnings, redemption premiums, or other lump-sum interest payments)[29] fall within its scope. Similarly, whether the debt claim is secured or unsecured is irrelevant for qualification under the directive. It is, however, required that an actual interest payment is made, as notional interest payments are excluded from the scope of the directive, as confirmed by the CJEU in *Viva Telecom Bulgaria*.[30] Similarly, payments on financial instruments without underlying debt (such as interest rate swaps[31] and guarantee fees[32]) are in my view, not covered by the directive.

25 *See* on the notion of "interest in general: J. Schwarz, 'Definition of Interest in the Context of Income from Capital: A Comparative Analysis' in G. Maisto (ed), *Taxation of Interest under Domestic Law, EU Law and Tax Treaties* (IBFD 2022), 3-10.

26 EU Commission (1991), Removal of tax obstacles to the cross-frontier activities of companies, Bulletin of the European Communities, Supplement 4/91, 52. *Similarly*: OECD Commentary on Article 11, para. 18.

27 EU Commission (1991), Removal of tax obstacles to the cross-frontier activities of companies, Bulletin of the European Communities, Supplement 4/91, 52. *Similarly*: OECD Commentary on Article 11, para. 18.

28 N. Saccardo, 'Selected Issues on the EU Definitions of Interest and Royalties', (2004) *Tax Notes International*, issue 9, 969-975, III.

29 *Similarly*: OECD Commentary on Article 11, para. 20.

30 Case C-257/20 *Viva Telecom Bulgaria* [2022] ECLI:EU:C:2022:125, para 55.

31 *Similarly*: OECD Commentary on Article 11, para. 21.1.

32 N. Saccardo, 'Selected Issues on the EU Definitions of Interest and Royalties', (2004) *Tax Notes International*, issue 9, 969-975, III.

Moreover, the directive's definition of interest is broad enough to cover hybrid financial instruments,[33] which exhibit characteristics of both debt and equity.[34] These instruments may include profit-participating loans, convertible bonds, or mezzanine financing arrangements, where the return to the investor may be contingent on the financial performance of the debtor.[35] However, while the scope of Article 2 is broad, it must be read in conjunction with Article 4, which provides Member States with the ability to withhold the benefits of the directive in certain situations, particularly in cases involving hybrid instruments (see Chapter 16).[36] **14.022**

(c) Payments that are excluded

The current text of the IRD explicitly excludes penalty charges from the scope of the directive. As indicated earlier (supra, A.2.), the European legislator has made a distinction between genuine income from capital and compensatory payments arising from delayed obligations. The accompanying commentary to the 1998 proposal explained this as follows: "Penalty charges for late payment do not really constitute income from capital, but are rather a special form of compensation for loss suffered through the debtor's delay in meeting his obligations. These charges are therefore, as in Article 11 of the OECD Model Tax Convention, not regarded as interest for the purposes of this Directive." **14.023**

The second explicit exclusion, which is also the only notable divergence between the OECD definition of interest and the version ultimately adopted in the IRD, concerns the exclusion of income from government bonds. While Article 11 of the OECD Model Convention includes interest derived from government securities within its scope, the directive deliberately omits such **14.024**

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33 *See* with regard to profit-participating certificates ('*Genussscheine*') in the context of the Austria-Germany tax treaty: case C-648/15 *Austria v. Germany* [2017] ECLI:EU:C:2017:664. Both countries involved did not contest whether those instruments fall within the scope of Article 11 OECD Model Convention (interest) as opposed to Article 10 dealing with dividends. *See* para 13 in particular: "While it is undisputed that the income from the certificates at issue is interest within the meaning of Article 11 of the Austro-German Convention, and not dividends within the meaning of Article 10 thereof, the Republic of Austria and the Federal Republic of Germany disagree on whether such interest falls under Article 11(1) or Article 11(2) of that convention."

34 E. Eberhartinger and M. Six, 'Taxation of Cross-Border Hybrid Finance: A Legal Analysis', (2009) *Intertax*, issue 1, 15; J. Bundgaard, 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1', (2010) *European Taxation*, issue 10, 444. *Similarly*: OECD Commentary on Article 11, para. 19.

35 Note that the CJEU has applied a strict interpretation of the notion "participation in profits" when interpreting Article 11(2) of the Austria-Germany tax treaty. *See* case C-648/15 *Austria v. Germany* [2017] ECLI:EU:C:2017:664, para 49.

36 M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot?' – Part 2', (2005) *European Taxation*, issue 2, 44.

income from its definition of interest. One commentator has referred to this exclusion as a “natural omission”.[37] In a report to the 1998 proposal (*supra*, A.2.), this income was labeled as “not relevant to this Directive”.[38] The rationale behind this exclusion is relatively straightforward: states are not companies and therefore do not fall within the personal scope of the directive.[39] In addition, it would be hard to imagine that the required “association” between debtor and creditor (see Chapter 15) would be fulfilled in such a case.[40] The directive was designed to regulate cross-border interest and royalty payments between associated companies within the EU. Government bonds, by contrast, are issued by states or public entities that do not meet the criteria for corporate taxpayers as defined in the personal scope of the directive (see Chapter 15).

(d) Capital gains on debt instruments

14.025 One area of ambiguity regarding the objective scope of the IRD concerns the treatment of certain capital gains, particularly in the context of bond transactions. In this context, capital gains refer to the profit realized by the holder of a security (such as a bond) when selling the financial instrument to another party. The amount received by the seller typically includes not only the bond’s initial (base) value but also the accrued interest that has accumulated since the last interest payment date but has not yet become payable at the time of sale. The question arises as to whether this accrued interest component, which is embedded within the sale price of the bond, falls within the scope of the directive’s definition of interest. In principle, capital gains from the sale of securities are generally treated conceptually as distinct from interest income. However, in some circumstances, national tax systems treat a portion of the gain realized upon the sale of a bond as accrued interest rather than as a capital gain, particularly in cases where the bond is sold to a tax-exempt entity. In such situations, states can prefer to tax the seller on the portion of the gain that represents accrued but unpaid interest, based on the idea that the interest component that is embedded in the sale price still retains its character as

37 J.D.B. Oliver, ‘The Proposed EU Interest and Royalties Directive’, (1991) *Intertax*, issue 6-7, 204.

38 Committee on Economic and Monetary Affairs and Industrial Policy, Report on the 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(98)0067 - C4-0195/98 - 98/0087(CNS)), 12.

39 J. Bundgaard, ‘Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1’, (2010) *European Taxation*, issue 10, 444.

40 M. Gusmeroli, ‘Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot?’ – Part 2’, (2005) *European Taxation*, issue 2, 44; C. Panayi, *European Union Corporate Tax Law* (Cambridge University Press 2021), 67.

interest income and should be taxed accordingly. According to one author, such income could be covered by the Directive.[41]

We are of the opinion that such an interpretation cannot be upheld for several reasons. First and foremost, a systematic reading of the preamble of the directive,[42] in conjunction with Article 1, makes it clear that the directive applies exclusively to interest (and royalty) *payments*. The directive does not extend its benefits to other forms of income, such as capital gains realized upon the sale or transfer of debt instruments. The explicit focus on payments of interest and royalties suggests that the scope of the directive is confined to periodic or lump-sum payments arising from an ongoing debtor-creditor relationship,[43] rather than gains realized from the disposal of an underlying financial instrument. One potential counterargument could be derived from the German language version of the directive, which refers to "*Einkünfte in Form von Zinsen*" (income in the form of interest). However, even under this broader linguistic formulation, the concept of income in the form of interest remains inherently limited to interest itself and does not extend to capital gains realized upon the transfer of the underlying debt instrument. **14.026**

Furthermore, a review of the legislative history of the directive confirms that the European legislator never intended for capital gains to be covered. Nowhere in the drafting process was it suggested that income arising from the sale of bonds or other debt instruments should fall within the scope of the IRD. Had the legislator intended to include capital gains, explicit language to that effect would have been incorporated into the directive. It is true that the OECD Commentary on Article 11 of the OECD Model Tax Convention suggests that accrued interest (provided that the State of source taxes the seller of the bond on such interest) could fall within the scope of the interest definition under bilateral tax treaties.[44] However, this OECD-based interpretation is not transposable to the EU context. Unlike tax treaties, which primarily aim to allocate taxing rights between contracting states, the IRD serves a different function: it seeks to harmonize the tax treatment of cross-border interest and royalty payments within the EU.[45] Additionally, it is important to note that **14.027**

41 J. Bundgaard, 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1', (2010) *European Taxation*, issue 10, 444.

42 Preambles 3, 4, and 5 IRD.

43 For example, speaking about an interested *creditor* in the context of the IRD: Case C-18/16 *Brisal*, Opinion of Advocate General Kokott [2016] ECLI:EU:C:2016:182, para 62.

44 OECD Commentary on Article 11, para. 20.1.

45 *See* Case C-397/09 *Scheuten Solar Technology* [2011] ECLI:EU:C:2011:499, paras 24-28; Case C-115/16, C-118/16, C-119/16 and C-299/16 *N Luxembourg 1 and Others* [2019] ECLI:EU:C:2019:134, paragraphs

the relevant paragraph in the OECD Commentary explicitly addressing this issue was only introduced in 2014, long after the adoption of the IRD. As a result, it cannot be considered indicative of the legislative intent behind the directive.

14.028 Further support for the restrictive interpretation of the directive's scope on this specific point can be found in the CJEU's ruling in the *Viva Telecom Bulgaria* case. In that case, the Court, following the opinion of AG Rantos,[46] held that notional interest (specifically, notional interest imputed on an interest-free convertible loan) does not qualify as interest under the IRD. The Court's reasoning was clear: "notional interest set by the tax authorities, such as that at issue in the main proceedings, cannot be regarded as interest payments for the purposes of Article 1(1) and Article 2(a) of Directive 2003/49, precisely since no payment has been made".[47] This judgment reinforces the idea that, for an income stream to fall within the directive's scope, there must be a genuine payment of interest by the debtor to the creditor. The directive's provisions apply exclusively to actual interest payments arising from a debt claim, rather than to theoretical or imputed amounts. By analogy, the same reasoning can be applied to capital gains arising from the sale of bonds or other debt instruments. Just as notional interest (which has not been actually paid) falls outside the scope of the directive, so too do capital gains, which do not originate from a debtor's obligation to pay interest but rather from fluctuations in the value of the financial instrument. Lastly, it should be noted that the now-repealed Interest Savings Directive, which was also adopted in 2003, explicitly listed "interest accrued or capitalised at the sale" in addition to a more generic definition of interest payments (see above).[48] The exclusion of similar wording in the IRD is once again an indication that such income should not be covered by the definition of "interest" in the IRD.

(e) Autonomous nature of the definition

14.029 The final adopted text of the directive, in contrast to the wording used in the second proposal, no longer includes a reference to the definitions of interest found in **tax treaties or domestic** law.[49] This omission represents a notable

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46 Case C-257/20 *Viva Telecom Bulgaria*, Opinion of Advocate General Rantos [2021] ECLI:EU:C:2021:779, para 54: "Where the tax authorities set and tax notional interest on an interest-free loan, the lender receives no interest and cannot therefore, in my view, be regarded as an 'actual beneficial owner' of that interest."

47 Case C-257/20 *Viva Telecom Bulgaria* [2022] ECLI:EU:C:2022:125, para 55.

48 Article 6(1)(b) Savings Directive.

49 Note that a limited number of tax treaties in turn refer to the EU IRD for their definitions. *See* Paragraph 16 of the Protocol (2001) to the Belgium-Netherlands Double Tax Treaty (2001): "[. . .] If an EEC

departure from the 1998 proposal, which had sought to align the directive's scope with the classifications established under bilateral tax agreements and national tax legislation. The removal of this provision restricts the applicability of the directive's benefits solely to payments that meet its autonomous definition, without allowing for a broader interpretation based on external legal sources. This is remarkable as the insertion of such a paragraph was suggested back in 1993 (*supra*, A.1), and this clause had been positively received in literature.[50] By allowing interest payments recognized under tax treaties or domestic law to fall within the directive's scope (and thus allowing the scope of the directive to be "open"), the provision helped to create a more flexible system. Arguably, the idea behind this provision was to give equal treatment to all types of payments regarded as interest, either by virtue of a tax treaty or by virtue of the domestic tax legislation of EU Member States.[51]

Its omission from the final text, therefore, marked a shift toward a more restrictive and "closed" (albeit broad) interpretation of interest under the directive.[52] While this removal narrows the scope of the directive, for which no explicit reason can be found,[53] it could in our opinion serve to prevent an overly broad application that could have extended benefits to situations not originally envisioned by the European legislator. **14.030**

directive regarding a common tax system for payments of interest and royalties between enterprises, as it may eventually be amended, the provisions of this directive, insofar as they depart from the provisions of paragraphs 2 and 3 of Article 11, shall apply insofar as interest is concerned." Article 11(5)(b) of the Netherlands-Portugal Double Tax Treaty (1999): "If an EC-Directive, which provides for a common tax treatment of interest and royalties paid between enterprises, enters into force and which may be changed from time to time, then with respect to such interest the provisions of that Directive shall be applicable instead of the provisions of this Article." Article III of the Protocol to the Spain-Switzerland Double Tax Treaty (1966) as amended through 2011: "As regards the application of Article 10, paragraph 2, subparagraph b) and of Article 12, paragraph 7, the terms used therein shall be defined according to Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States and Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States."

50 J.D.B. Oliver, 'The Proposed EU Interest and Royalties Directive', (1991) *Intertax* issue 6-7, 204.

51 S.M. Fernandes, F. Bernales, S. Goeydeniz, B. Michel, O. Popa and E. Santoro, 'A comprehensive Analysis of Proposals to Amend the Interest and Royalties Directive – Part 2', (2010) *European Taxation*, issue 11, 452.

52 J. López Rodriguez, 'Commentary on the Interest and Royalties Directive' in O. Thömmes and E. Fuks (eds), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD 2008), no. 105; S.M. Fernandes, F. Bernales, S. Goeydeniz, B. Michel, O. Popa and E. Santoro, 'A comprehensive Analysis of Proposals to Amend the Interest and Royalties Directive – Part 2', (2010) *European Taxation*, issue 11, 451.

53 B.J.M. Terra and P.J. Wattel, *European Tax Law* (Kluwer 2012), 774.

14.031 At the time of its introduction, this provision had already sparked debate in academic literature. One of the key concerns raised was whether the clause could enable Member States to circumvent the application of the directive by categorizing interest payments under a different label, such as *technical fees* or another form of remuneration not explicitly covered by the directive.[54] This possibility led to discussions on whether such a classification strategy could be exploited as a means of avoiding the directive's intended tax relief provisions, thereby undermining its effectiveness in facilitating cross-border interest and royalty payments within the EU. However, in our view, such an interpretation is not tenable. Allowing Member States to unilaterally reclassify payments in this manner would fundamentally undermine the directive's objectives and disrupt the uniformity of its application across the EU.[55] Indeed, Member States must apply EU directives in a manner that upholds their objectives rather than undermining them through unilateral national classifications.

14.032 By relying exclusively on the directive's internal (autonomous) definition of interest,[56] the final text ensures a more consistent and uniform application across Member States, minimizing the risk of interpretative discrepancies. This approach establishes a clear framework for determining whether a payment qualifies as interest within the meaning of the directive, independent of national tax classifications. However, the exclusion of references to domestic and treaty-based definitions raises important questions regarding the directive's interaction with national tax systems. Under the current text, two possible scenarios may arise concerning the interplay between the directive's definition and national legislation:[57]

- The directive qualifies income as interest, but the domestic legislation does not. In this case, since the directive's autonomous definition prevails, the income in question will fall within the scope of the directive, and the Member State will be required to grant the applicable benefits. This ensures that payments meeting the directive's definition are consistently treated as interest across the EU, even if national law would not classify them as such.
- The domestic legislation qualifies income as interest, but the directive does not. In this scenario, the income is not covered by the directive, meaning the directive's

54 J.D.B. Oliver, 'The Proposed EU Interest and Royalties Directive', (1991) *Intertax* issue 6-7, 204.

55 D. Weber, 'The proposed EC Interest and Royalty Directive', (2001) *EC Tax Review*, issue 1, 25.

56 *See* regarding the autonomous nature of the notions included in the IRD in general: G. Kofler, 'Open Issues in the Application of the EU Interest- Royalties Directive ' in G. Maisto (ed), *Taxation of Interest under Domestic Law, EU Law and Tax Treaties* (IBFD 2022), 61-66.

57 S.M. Fernandes, F. Bernales, S. Goeydeniz, B. Michel, O. Popa and E. Santoro, 'A comprehensive Analysis of Proposals to Amend the Interest and Royalties Directive – Part 2', (2010) *European Taxation*, issue 11, 452.

benefits (e.g., exemption from withholding tax) will not apply. Member States are not obliged to extend its benefits to payments that do not meet its criteria.

In our view, however, in this second scenario, nothing prevents a Member State from voluntarily granting equivalent benefits under its national law. While the directive does not mandate such an approach, Member States remain free to "over-implement" its provisions by extending similar tax relief to payments that do not strictly fall within the directive's scope. This discretionary over-implementation and an extension of benefits would be a matter of national policy rather than a requirement under the directive itself. **14.033**

It is worth noting that the now-repealed Savings Directive (Council Directive 2003/48/EC)[58] also contained a specific definition of "*interest* payment", which was set out in Article 6 of that directive.[59] While the definition in Article 6 bore a resemblance to the definition provided in Article 2 IRD, it also contained notable deviations. One distinction was the explicit inclusion of income from government securities,[60] which is absent from the IRD's definition. This broader approach in the Savings Directive reflected the different policy objectives underpinning that directive, which was primarily concerned with ensuring effective taxation of savings income across Member States, particularly in the context of individual taxpayers. We concur with the view that, due to the fundamental differences between the two directives (including their specific objectives, scope, and target groups), the definition of interest payment under the Savings Directive should not be used as a reference point for interpreting the IRD.[61] **14.034**

Lastly, there have been extensive debates in literature on whether the OECD Model Tax Convention and its commentaries can be used to interpret notions included in the IRD and if so, which version (i.e., the version in force at the moment the IRD was adopted or later amendments, in other words, a static or **14.035**

58 Council Directive 2003/48/EC of June 2003 on taxation of savings income in the form of interest payments, OJ L 157, 26.6.2003, p. 38-48.

59 "For the purposes of this Directive, 'interest payment' means: (a) interest paid or credited to an account, relating to 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, and, in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payments shall not be regarded as interest payments; (b) interest accrued or capitalised at the sale, refund or redemption of the debt claims referred to in (a) [. . .]." In addition, the Savings Directive explicitly covered interest payments received by certain entities (UCITS).

60 Article 6(1)(a) Savings Directive.

61 J. López Rodriguez, 'Commentary on the Interest and Royalties Directive' in O. Thömmes and E. Fuks (eds), EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation (IBFD 2008), no. 107.

dynamic approach). It cannot be denied that given the legislative history of the provision in question, the EU definition has a strong connection to the OECD definition. As one author explains: "The text is the same as that used in the definition of interest in Art. 11 of the OECD Model Tax Convention. This is important, as the Member States of the European Union, who are also members of the OECD, are conversant with the Model and its Commentaries. Thus, the international principles in this area of taxation, as collated in the OECD documents, have been a source of reference for the directive. If that had not been the intention, Art. 2 would have been drafted differently."[62]

14.036 However, authors have been cautious of overreliance on OECD Commentaries given the autonomous nature of the EU definition.[63] Indeed, while the OECD Commentary might provide useful guidance, "it is quite a different question whether the contents of that Commentary must be considered to be binding in this respect".[64] The CJEU has taken a liberal stance and has acknowledged the value of the OECD model and commentaries, even adopting a dynamic approach: "the directive draws upon Article 11 of the OECD 1996 Model Tax Convention and pursues the same objective, namely avoiding international double taxation. The concept of 'beneficial owner', which appears in the bilateral conventions based on that model, and the successive amendments of that model and of the commentaries relating thereto are, therefore, relevant when interpreting Directive 2003/49."[65]

B. THE DEFINITION OF "ROYALTY" IN ARTICLE 2(B)

1. The original proposal (1990)

14.037 In the original Commission proposal that was presented on 28 November 1990,[66] but which was later withdrawn, royalties were defined as follows in

62 J. López Rodriguez, 'Commentary on the Interest and Royalties Directive' in O. Thömmes and E. Fuks (eds), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD 2008), no. 105.

63 S.M. Fernandes, F. Bernales, S. Goeydeniz, B. Michel, O. Popa and E. Santoro, 'A comprehensive Analysis of Proposals to Amend the Interest and Royalties Directive – Part 2', (2010) *European Taxation*, issue 11, 452-454.

64 A. Cordewener, 'The Interest and Royalties Directive', in S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2023), 625.

65 Case C-115/16, C-118/16, C-119/16 and C-299/16 N Luxembourg 1 and Others [2019] ECLI:EU:C:2019:134, paragraphs 85-86.

66 Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States (COM (90) 571 final),

Article 2(b): "'royalties' means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience". The adjoining explanatory memorandum explicitly linked this definition in the IRD to Article 12 of the 1977 OECD Model Convention,[67] suggesting the will to align with international tax principles.

According to the commentary, it is necessary to distinguish between *payments for the use of equipment* and *payments constituting consideration for the sale of equipment*. The commentary makes it clear that while *payments for the use of equipment* qualify as *royalties* under the directive, payments related to the *sale of such equipment* do not. This distinction is particularly relevant in the context of leasing arrangements. According to the memorandum, a leasing contract is generally characterized by a principal purpose of "hire", even when it includes an option for the lessee to purchase the equipment outright during the lease term. In such cases, the payments made by the lessee during the lease period are considered rentals and therefore fall within the scope of the IRD's royalty definition.[68] **14.038**

This approach aligned with the 1977 OECD Commentary, which similarly recognized that *rental payments* for the use of industrial, commercial, or scientific equipment should be treated as *royalties*, provided the underlying contract is structured as a lease rather than a sale: "the sole, or at least the principal, purpose of the contract is normally that of hire, even if the hirer has the right thereunder to opt during its term to purchase the equipment in question outright. Article 12 therefore applies in the normal case to the rentals paid by the hirer, including all rentals paid by him up to the date he exercises any rights to purchase."[69] **14.039**

According to the OECD, a clear distinction must be made between leasing agreements (including lend-lease arrangements) and credit sale agreements or **14.040**

OJ C 53, 28.2.1991, 26–29. *See* for an analysis of this proposal: O. Thömnes, "The new EC Commission's proposals for directives on cross-border investments", (1991) *Intertax*, issue 3, 158-165.

67 EU Commission (1991), Removal of tax obstacles to the cross-frontier activities of companies, Bulletin of the European Communities, Supplement 4/91, 52

68 EU Commission (1991), Removal of tax obstacles to the cross-frontier activities of companies, Bulletin of the European Communities, Supplement 4/91, 52

69 1977 OECD Commentary on Article 12, para. 9.

hire-purchase agreements. The key difference lies in the economic substance of the transaction: in a leasing arrangement, the primary purpose is the temporary use of the asset, whereas in a credit sale or hire-purchase agreement, the primary objective is the eventual transfer of ownership. In the case of credit sale agreements and hire-purchase agreements, the sale element is considered "paramount". This is because the parties have, from the outset, agreed that ownership of the asset will ultimately be transferred from the seller (or lessor) to the buyer (or hirer). Although legal ownership remains with the seller/lessor until the final installment is paid, the agreement is structured in such a way that ownership transfer is an integral part of the transaction. As a result, the installments paid by the purchaser or hirer under a credit sale or hire-purchase agreement do not, in principle, constitute royalties within the meaning of Article 12 of the (1977) OECD Model Tax Convention.

14.041 The explanatory memorandum also clarifies that the reference to royalties paid as consideration for *information concerning industrial, commercial, or scientific experience* pertains specifically to know-how agreements. This reference could also be found in the 1977 version of the commentary to Article 12 of the OECD Model Tax Convention.[70] In a know-how contract, one party agrees to share their technical knowledge and expertise with another party, enabling the recipient to use this information for their own business activities. This type of agreement is distinct from *technical service* contracts, where the provider actively applies their expertise to perform a service rather than transferring knowledge to the recipient.

14.042 The memorandum also identifies certain types of payments that are explicitly excluded from the royalties definition under the directive: (i) payments for after-sales services; (ii) payments for services rendered by a seller to a purchaser under a guarantee; (iii) payments for pure technical assistance; and (iv) payments for "an opinion".[71] The reasoning behind these exclusions is that such payments arise from contracts for the provision of services, where one party undertakes to personally execute work using their professional expertise, rather than transferring rights to intellectual property or know-how. This distinction ensures that the IRD remains focused on *passive* income derived from the licensing of intellectual property and industrial knowledge, rather than extending its benefits to payments for *active* service provision. Once more, each of these examples can be traced to the 1977 version of the commentary to

70 1977 OECD Commentary on Article 12, para. 12.

71 EU Commission (1991), Removal of tax obstacles to the cross-frontier activities of companies, Bulletin of the European Communities, Supplement 4/91, 52.

Article 12 of the OECD Model Tax Convention.[72] Lastly, it should be noted in this regard that the Economic and Social Committee issued an opinion on 20 March 1991 on the proposal stating, "It should be borne in mind moreover that the OECD Tax Affairs Committee has spoken out clearly against withholding taxes on non-royalty payments, arising from agreements within a group of companies, or contributions from affiliated companies to central research costs or joint services."[73]

2. The second proposal (1998)

(a) General

On 4 March 1998, a second proposal was published by the Commission,[74] which expanded the existing wording of the "royalties" definition. To illustrate the evolution of the wording, the text of the 1998 proposal is compared below to the text of the 1990 proposal. **14.043**

1990 Proposal	1998 Proposal
"royalties" means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience	"royalties" means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, scientific work or ***software***, including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for the use of or the right to use industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience. ***Variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources shall be excluded, as well as payments for the use of, or the right to use, software when ownership is transferred.***

According the Commentary on Article 2, the term "royalties" denotes in general "all payments made as a consideration for the use of, or the entitlement to use copyright, works, patents, and so on. as included in Article 12 of the **14.044**

72 1977 OECD Commentary on Article 12, para. 12.

73 Opinion of the Economic and Social Committee on the proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States (COM(90) 571 final), ECO/144 A, 20 March 1991, OJ C 120/16, 6.5.91.

74 *See* for an analysis of this proposal: J.D.B. Oliver, 'The Proposed EU Interest and Royalties Directive', (1991) *Intertax* issue 6-7, 204-206; D. Weber, 'The proposed EC Interest and Royalty Directive', (2001) *EC Tax Review*, issue 1, 15-30.

1996 OECD Model Tax Convention on income and on capital, as well as payments made in consideration for the use of or the right to use industrial, commercial or scientific equipment, in order to cover all payments considered by Member States to be royalties." Once more, the link with the OECD Model Tax Convention is made very clear. However, despite this alignment, some notable differences exist between the IRD and the OECD framework.[75]

14.045 The most significant deviation involves the introduction of software payments into the definition of *royalties*. This inclusion is particularly noteworthy because the 1996 version of the OECD Model Tax Convention did *not* contain a similar reference to software payments. In fact, at the time, the OECD recognized that the classification of *consideration for software* was complex, as it was difficult to draw a clear distinction between payments that should be properly regarded as royalties and those that fell outside the scope of the royalty definition.[76] This deviation suggests that the inclusion of software in the 1998 IRD proposal was a deliberate policy decision by the European legislator, possibly reflecting the growing economic importance of software-related transactions and the need to provide tax certainty for cross-border licensing agreements within the EU.

14.046 To address this ambiguity, the 1996 OECD Commentaries identified *three distinct situations* of software-related payments, each requiring separate tax treatment.[77] These categories were established to provide guidance on where the boundary should be drawn between *software payments that qualify as royalties* and those that represent *other types of income* (e.g., business profits or service fees). First, situations where "less than the full rights in software are transferred" (i.e., a partial transfer of rights) are considered. According to the OECD, payments in this situation are likely to represent a royalty only in very limited circumstances, including where rights are made at the disposal of a third party, "enabling the latter to exploit the software itself commercially,

75 It should be noted that the Economic and Social Committee has issued an opinion on the scope of the royalty definition in the 1998 proposal: "Payments made by way of contributions to a group's central research expenditure must specifically be covered by the exemption from withholding tax. The OECD Fiscal Affairs Committee has clearly stated that no withholding tax should be levied on payments that do not represent royalties but result from agreements on contributions to a group's central expenditure. Hence Article 2(1)(b) should read: '... or for information concerning industrial, commercial or scientific experience which has been, or is in the process of being, acquired. Variable ...'". *See* Opinion of the Economic and Social Committee on the '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 (98/C 284/09), OJ C 284/54 (14.9.98).

76 1996 OECD Commentary on Article 12, para. 12.

77 1996 OECD Commentary on Article 12, paras 13-17.

for example by development and distribution of it".[78] Second, situations where payments are made as consideration for the alienation of rights attached to the software cannot represent a royalty in the scope of Article 12.[79] Third, in the case of mixed contracts (e.g., sale of computer hardware with built-in software), it is advised to apply a "reasonable apportionment".[80]

In the Commentary on Article 2 of the 1998 IRD proposal, the following explanation is given: "Payments made in consideration for software may represent royalties if less than the full rights in the software are transferred (no alienation of ownership), i.e. payments made under transactions in software copyrights that allow the transferee to commercially exploit the copyright by using it to reproduce computer software products for sale or by sublicensing the copyright to other parties, but which do not constitute an alienation of the copyright." In essence, this is analogous to the first situation that was described by the OECD in its 1996 Commentaries.[81] **14.047**

Furthermore, the 1998 IRD proposal explicitly excludes from its scope situations where ownership of software is transferred (cf. situation 2 in the 1996 OECD Commentaries). This exclusion, which was embedded in the text of the directive itself, reinforces the distinction between software license payments (which are treated as royalties) and software sales, where full ownership of the software is transferred. By drawing this line, the directive follows the traditional approach of limiting royalty treatment to payments made for the right to use software, while excluding one-time payments that result in a full transfer of ownership. However, while the directive provides clarity on pure licensing and full ownership transfer, it does not offer specific guidance on the third category (i.e. mixed contracts) that were identified in the OECD Model Commentaries. **14.048**

In addition, in the 1996 version of Article 12 of the OECD Model Tax Convention, the sentence "for the use of, or the right to use, industrial, commercial or scientific equipment" was deleted, deviating from the 1977 version of that article. This was explained as follows: "Given the nature of income from the leasing of industrial, commercial or scientific equipment, including the leasing of containers, the Committee on Fiscal Affairs decided to exclude income from such leasing from the definition of royalties and, consequently, to **14.049**

78 1996 OECD Commentary on Article 12, para 13.
79 1996 OECD Commentary on Article 12, para 15.
80 1996 OECD Commentary on Article 12, para 17.
81 1996 OECD Commentary on Article 12, para 13.

remove it from the application of Article 12 in order to make sure that it would fall under the rules for the taxation of business profits, as defined in Articles 5 and 7".[82] In the 1998 IRD proposal, this sentence was retained, again indicating a clear policy choice by the European legislator.

14.050 Lastly, the text of the 1998 proposal explicitly excludes variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. According to the Commentary on Article 2, such "mineral royalties" are excluded, as such payments "have rather the character of income from real estate". This view was already expressed in paragraph 13 of the 1977 OECD Commentaries on Article 12.[83]

(b) Reference to tax treaties and domestic law

14.051 A second paragraph was included in Article 2, further broadening the scope of the definition of interest: "The Directive applies not only to the payments of interest or royalties as defined under paragraph 1 but also to all payments regarded by Member States as such, either under a Double Taxation Convention in force between the Member State where the interest or royalties arise and the Member State of the beneficial owner or, in the absence of such a Convention, on the basis of the national tax legislation of the Member State where the interest or royalties arise. This extends to payments made by or to a permanent establishment which would be considered to be interest or royalties if they had been made by or to a company in the Member States concerned". For a discussion of this provision, we refer to *supra*, A.2.b.

3. The current text

(a) General

14.052 The current text of Article 2 remains largely unchanged from the version adopted in the 1998 proposal.[84] The only notable difference is that the exemplative list of financial instruments covered by the directive has been expanded to explicitly include securities, in addition to the previously mentioned bonds and debentures.

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82 1996 OECD Commentary on Article 12, para. 9.

83 1977 OECD Commentary on Article 12, para. 13. *Compare*: 1996 OECD Commentary on Article 12, para. 19.

84 For a general discussion, including reference to the OECD definition: C. Brokelind, 'Royalty Payments: Unresolved Issues in the Interest and Royalties Directive', (2004) *European Taxation*, issue 5, 252-258.

1998 Proposal	Current text
"royalties" means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, scientific work ~~or software~~, including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, ~~or for the use of or the right to use industrial, commercial or scientific equipment~~, or for information concerning industrial, commercial or scientific experience. ~~Variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources shall be excluded~~, ~~as well as payments for the use of, or the right to use, software when ownership is transferred.~~	"royalties" means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films ***and software***, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; ***payments for the use of, or the right to use, industrial, commercial or scientific equipment shall be regarded as royalties.***

(b) Payments that are covered

Payments for any copyright of literary, artistic or scientific work, including cinematograph films and software

14.053 The first category of payments covered by the royalty definition in the IRD relates to *payments made for the use of, or the right to use, any copyright*.[85] This category encompasses payments made under a licensing arrangement, such as fees paid for the right to use *literary copyrights* granted by a publisher. It includes cases of compensation in which a party would be obliged to pay for fraudulently copying or infringing the right in question.[86] A non-exhaustive list of examples is provided within the definition to illustrate the types of rights and subject matter that may fall within this category.

14.054 The first example cited (i.e., copyright in cinematographic films) is directly drawn from the OECD's definition of royalties in Article 12 of the Model Tax Convention. According to the OECD Commentary, the treatment of such payments as royalties is unaffected by the medium of exploitation. It is

85 In literature, it is argued that EU legislation on intellectual property can aid in the interpretation of this notion. *See*: J. López Rodriguez, 'Commentary on the Interest and Royalties Directive' in O. Thömmes and E. Fuks (eds), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD 2008), no. 124.

86 Compare: 2019 OECD Commentary on Article 12, para. 8. *See* also J. López Rodriguez, 'Commentary on the Interest and Royalties Directive' in O. Thömmes and E. Fuks (eds), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD 2008), no. 120; P. Arginelli, 'Open Issues in the Application of the EU Interest- Royalties Directive to Royalty Payments ' in G. Maisto (ed), *Taxation of Intellectual Property under Domestic Law, EU Law and Tax Treaties* (IBFD 2018), 55-58.

therefore irrelevant whether the cinematographic works are exhibited in cinemas or broadcast on television.[87] The same conclusion can, in our opinion, be upheld in case the works are distributed through other media, such as streaming platforms. The focus remains on the legal right to use the copyrighted material and the corresponding consideration paid for that right.

14.055 The second example is payments for software.[88] These payments are, in a notable deviation from the definition of royalties under Article 12 of the OECD Model Tax Convention, explicitly included in the IRD definition of royalties. This inclusion can be seen as a deliberate policy choice by the EU legislator to address the growing importance of software in cross-border commercial transactions. A first point of interest is the fact that software is included in the category of payments for any *copyright of literary, artistic or scientific work*, an approach that is also taken under the OECD Commentaries.[89] The Directive avoids this discussion by expressly providing that payments for the use (or the right to use) software are covered by that limb of the royalty definition. A second remarkable point is the change that occurred between the 1998 proposal and the final adopted text: the explicit exclusion of payments relating to the transfer of ownership of software, which had been present in the 1998 draft, was removed in the final version. In our opinion, this deletion should not be interpreted as an intention to bring such payments within the scope of the directive. A closer examination of the current wording and structure of the royalty definition strongly suggests that the directive continues to cover only payments made for the use of, or the right to use, software. In other words, the directive aims to cover licensing arrangements. The reference to software is clearly embedded in the context of use-based payments, consistent with the

87 Compare: 2019 OECD Commentary on Article 12, para 10.

88 Under the OECD Model Convention (Article 12, paragraph 12.1), software is defined as "a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing or electronically, on a magnetic tape or disk, or on a laser disk or CD-ROM. It may be standardized with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware."

89 2019 OECD Commentary on Article 12, para 13.1: "should be noted that where a software payment is properly to be regarded as a royalty there may be difficulties in applying the copyright provisions of the Article to software payments since paragraph 2 requires that software be classified as a literary, artistic or scientific work. None of these categories seems entirely apt. The copyright laws of many countries deal with this problem by specifically classifying software as a literary or scientific work. For other countries treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 which either omits all references to the nature of the copyrights or refers specifically to software."

overall structure of Article 2, which restricts the concept of royalties to payments in consideration for the use of rights, rather than for their outright sale. This interpretation is also strongly supported by the legislative history of the provision. Although the exclusion for sales was later removed, there is no indication that the removal was intended to broaden the scope of the directive to include such payments.

Following the OECD's approach, which is acceptable to apply on the basis of the commentary to the 1998 draft, it can be concluded that payments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright.[90] This includes, for example a license to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program.[91] The same applies to the situation where a software house or computer programmer agrees to supply information about the ideas and principles underlying the program, such as logic, algorithms, or programming languages or techniques. In the latter cases, the payments may be characterized as royalties to the extent that they represent consideration for the use of, or the right to use, secret formulas or for information concerning industrial, commercial or scientific experience,[92] which are also covered under the IRD. Payments for the acquisition of limited rights on software (i.e., a program copy) without allowing the purchaser to commercially exploit the copyright are not covered by the definition.[93] **14.056**

As indicated earlier (*supra*, B.2), the directive does not provide guidance for "mixed contracts". It is, however, highly doubtful whether the OECD's apportionment method, which was originally developed to distinguish between royalties and business income, can be directly and uncritically applied within the framework of IRD.[94] The Directive adopts a distinct legal and structural approach, grounded in its own objectives, which differ meaningfully from **14.058**

90 J. López Rodriguez, 'Commentary on the Interest and Royalties Directive' in O. Thömmes and E. Fuks (eds), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD 2008), no. 133.

91 Compare: 2019 OECD Commentary on Article 12, para 13.1.

92 Compare: 2019 OECD Commentary on Article 12, para 14.3.

93 Compare: 2019 OECD Commentary on Article 12, para 14.

94 *Differently*: J. López Rodriguez, 'Commentary on the Interest and Royalties Directive' in O. Thömmes and E. Fuks (eds), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD 2008), no. 131.

those underpinning the OECD Commentaries on this point. As such, the mechanical application of the OECD apportionment methodology may not align with the internal logic or teleological objectives of the directive. This divergence becomes particularly problematic in the context of mixed contracts, where a single lump-sum fee may reflect several elements: for instance, a combination of licensing of know-how, software access, technical services, and the supply of tangible goods (e.g., hardware). In the absence of an explicit breakdown of the price in the contractual documentation, the challenge becomes determining whether and how such a fee can be apportioned for the purposes of applying the directive. While the OECD suggests a reasonable apportionment approach in such situations, such an approach raises serious concerns, particularly in light of the CJEU's consistent position on the requirement for actual payments and clearly identifiable remuneration. In *Viva Telecom Bulgaria*, the Court has made clear that notional or imputed payments do not fall within the scope of the directive.[95] Extending this logic, it becomes questionable whether, in the absence of a contractually agreed split, a single composite fee can be divided into hypothetical royalty and non-royalty components for the purposes of applying Article 2 IRD. In other words, unless the contract itself explicitly separates the remuneration attributable to the right to use intellectual property from payments for services or goods, reliance on a "reasonable apportionment" may run counter to both the letter and the spirit of the directive. In such cases, there is a real risk that the entire payment would fall outside the IRD's scope due to the absence of a clearly defined royalty component.

Payments for a patent, trade mark, design or model, plan, secret formula or process

14.059 In this category of royalty payments, the distinction between licensing and the provision of services becomes particularly important. A payment cannot be regarded as a royalty if it is made in consideration for the *creation* or *development* of the relevant intellectual property. For example, if a payment is made to a designer or architect for the development of a new design, model, or plan, the payment is not for the use of a preexisting right, but rather for the services rendered in creating that right. This applies even if the service provider retains all intellectual property rights, including copyright, in the developed work.[96] In contrast, where the recipient of the payment is the owner of the intellectual property, for example, an architect who has previously developed plans, and merely grants a right to use or reproduce those plans without undertaking any

95 Case C-257/20 *Viva Telecom Bulgaria* [2022] ECLI:EU:C:2022:125, para 55.

96 Compare: 2019 OECD Commentary on Article 12, para 10.2.

additional creative or technical work, the payment received constitutes a royalty. The main factor is that the transaction involves the licensing of an *existing* intangible asset, not the performance of new services.

This distinction is consistent with both the OECD Commentary and the directive's focus on passive income derived from the use of intellectual property, as opposed to active income earned through services (see also below). Where the transaction involves access to or reproduction of preexisting intellectual property without further services, the payment will generally qualify as a royalty under the IRD. **14.060**

Payments for information concerning industrial, commercial or scientific experience

The notion of payment for information within the meaning of the IRD pertains specifically to know-how agreements. Under such agreements, one party undertakes to share its technical knowledge, experience, and expertise with another party, thereby enabling the recipient to independently use that information in its own business activities. The defining feature of a know-how contract is the transfer of the right to use industrial, commercial, or scientific experience rather than the performance of a service. **14.061**

The principal difficulty in delineating income from know-how lies in distinguishing it from technical service contracts or technical assistance agreements. While the line between the two can be subtle, the distinction is conceptually significant. In a technical service contract, the provider applies their expertise directly in the execution of a task or service for the client, often without transferring any rights or ongoing benefit.[97] Even where such services involve the application of specialized knowledge, they do not entail the transfer of the use of that knowledge to the client. This distinction has important implications for the scope of the IRD. Payments made under know-how contracts qualify as royalties because they reflect *passive* income arising from the licensing or transfer of intangible assets. In contrast, payments made under service contracts are considered *active* income and therefore fall outside the directive's scope. **14.062**

The notion of payment for information pertains specifically to know-how agreements. Under a know-how contract, one party agrees to share their technical knowledge and expertise with another party, enabling the recipient to use this information for their own business activities. The main issue in **14.063**

97 *See* a.o. A. Martín Jiménez, 'Article 12: Royalties - Global Tax Treaty Commentaries', *Global Tax Treaty Commentaries*, Global Topics IBFD.

delineating this income lies in the distinction with technical service contracts or technical assistance contracts. The provision of technical services does not imply the transfer of use of such property to the client, even if it can be applied by the service provider when the service is performed. This distinction ensures that the IRD remains focused on *passive* income derived from the licensing of intellectual property and industrial knowledge, rather than extending its benefits to payments for *active* service provision.

Payments for the use of, or the right to use, industrial, commercial or scientific equipment

14.064 From the outset of the legislative process, it was clear that royalties for the use of equipment were intended to fall within the scope of the IRD. This was already established in the original Commission proposal of 1990, and despite subsequent changes to international tax standards, this position remained unchanged throughout the directive's evolution. Notably, this type of income continued to be included in the IRD even after the corresponding language was removed from Article 12 of the OECD Model Tax Convention in its 1996 update. Under the OECD framework, income from leasing equipment was increasingly viewed as more appropriately dealt with under the provisions on business profits, rather than as royalties.[98] Nevertheless, the European Union legislator chose to retain the broader approach in the IRD. The continued inclusion of equipment royalties under the IRD has practical advantages. It avoids difficult distinctions between the finance or interest component and the rental element in lease payments, since both interest and royalties fall under the scope of the directive, enhancing legal certainty in the context of leasing arrangements.

14.065 According to the commentary to the 1990 proposal, royalties paid under a leasing contract fall within the IRD's scope, even if the lease includes an option for the lessee to purchase the equipment during the term.[99] In our opinion, this interpretation remains valid, as the relevant wording of the directive has remained unchanged in this respect. The key determinant is the substance of the agreement: the primary purpose must be the *temporary* use of the asset. If the parties agree from the outset that ownership of the equipment will be transferred at the end of the lease, then the agreement is best characterized as a sale, rather than a lease, and the payments made under such a contract should

98 S.M. Fernandes, F. Bernales, S. Goeydeniz, B. Michel, O. Popa and E. Santoro, 'A comprehensive Analysis of Proposals to Amend the Interest and Royalties Directive – Part 2', (2010) *European Taxation*, issue 11, 452.

99 EU Commission (1991), Removal of tax obstacles to the cross-frontier activities of companies, Bulletin of the European Communities, Supplement 4/91, 52.

be treated as sale price installments, not royalties.[100] In contrast, if the lessee merely has the *option* (rather than an *obligation*) to acquire the asset, then all payments made prior to exercising that option should continue to be treated as royalties under the directive.

It is worth noting that the IRD itself does not provide a definition of the term "equipment". The absence of a precise definition raises questions about the exact scope of the provision. It is our opinion that this notion should also be seen as an autonomous EU notion (see *infra*, (d)).[101] Given the goals of the IRD and the wording of the provision ("industrial, commercial or scientific"), a broad definition is, in our opinion, envisaged.[102] The notion should include a broad range of *tangible* assets such as machinery, vehicles, laboratory tools, and technical installations. Reference can also be made to the Commentary on the UN Model Convention,[103] which mentions the following (non-exhaustive) list of equipment: "ships, aircraft, cars and other vehicles, cranes, containers, satellites, pipelines and cables".[104] **14.066**

(c) Payments that are excluded

Aside from the abovementioned explicit exclusions, it follows from the text of the Directive and its legislative history that the following types of income are equally excluded. These payments have a common characteristic in that they indicate the transfer of ownership or the active intervention of the supplying party: **14.067**

- Payments for the acquisition of limited rights on software (i.e. sale of a program copy, site licenses, enterprise licenses, or network licenses) without allowing the purchaser to commercially exploit the copyright. Similarly, a fee for a software download for the purchaser's own use, including payments for software as a service (SaaS) and other cloud-based delivery models, is excluded from the scope of the IRD.

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100 It could be argued that this should be interpreted following a substance-over-form approach which would exclude perpetual licenses: *See* for a critical analysis of long-term of perpetual licenses: N. Saccardo, 'Selected Issues on the EU Definitions of Interest and Royalties', (2004) *Tax Notes International*, issue 9, 969-975, IV.

101 Note that the 1977 version of the OECD Commentaries also does not provide a definition or guidance as to the interpretation of this notion.

102 *Similarly*: S.M. Fernandes, F. Bernales, S. Goeydeniz, B. Michel, O. Popa and E. Santoro, 'A comprehensive Analysis of Proposals to Amend the Interest and Royalties Directive – Part 2', (2010) *European Taxation*, issue 11, 452.

103 For a critical assessment: A. Martín Jiménez, 'Article 12: Royalties - Global Tax Treaty Commentaries', *Global Tax Treaty Commentaries*, Global Topics IBFD at 5.1.6.3.

104 2021 UN Commentary on Article 11, para 19.

- Payments made under an agreement where the provider *actively* applies their expertise to perform a service rather than transferring knowledge to the recipient, such as technical services or technical assistance. This includes payments for after-sales services, services rendered by a seller to a purchaser under a guarantee, and payments for "an opinion".[105]
- All types of non-royalty intragroup payments or contributions from affiliated companies to central research costs or joint services.
- Payments made under an equipment lease agreement for the purchase of the equipment and fees paid after the exercise of the purchase option.[106]
- Payments made in the context of an outright sales contract, including fees paid under arrangements where the primary objective is the eventual transfer of the asset, such as payments in the context of a credit sale or a hire-purchase agreement.
- Other types of payments not meeting the abovementioned criteria (*supra*, B.3.a), such as fees for "transponder leasing",[107] payments under a roaming agreement,[108] fees for a "spectrum lease",[109] the consideration paid for an exclusive right to sell,[110] and the sale of a customer list.[111]
- Variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources ("mineral royalties") are excluded.[112]

(d) Autonomous nature of the definition

14.068 The final adopted text of the directive, in contrast to the wording used in the second proposal, no longer includes a reference to the definitions of royalties found in **tax treaties or domestic** law.[113] This omission represents a notable

105 *Compare*: 2019 OECD Commentary on Article 12, para 11.4.

106 *See* for a critical analysis of long-term or perpetual licenses: N. Saccardo, 'Selected Issues on the EU Definitions of Interest and Royalties', (2004) *Tax Notes International*, issue 9, 969-975, IV.

107 *Compare*: 2019 OECD Commentary on Article 12, para 9.1.

108 *Compare*: 2019 OECD Commentary on Article 12, para 9.2.

109 *Compare*: 2019 OECD Commentary on Article 12, para 9.3.

110 *Compare*: 2019 OECD Commentary on Article 12, para 10.1.

111 *Compare*: 2019 OECD Commentary on Article 12, para 11.4.

112 This exclusion was explicitly present in the text of the 1998 proposal as they "have rather the character of income from real estate". Based on the types of royalty income that are covered, it is only logical that this type of remuneration is excluded from Article 2 IRD. *Compare*: 2019 OECD Commentary on Article 12, para 19.

113 Note that a limited number of tax treaties in turn refer to the EU IRD for their definitions. *See* Paragraph 16 of the Protocol (2001) to the Belgium-Netherlands Double Tax Treaty (2001): "[. . .] If an EEC directive regarding a common tax system for payments of interest and royalties between enterprises, as it may eventually be amended, the provisions of this directive, insofar as they depart from the provisions of paragraphs 2 and 3 of Article 11, shall apply insofar as interest is concerned." Article 11(5)(b) of the Netherlands-Portugal Double Tax Treaty (1999): "If an EC-Directive, which provides for a common tax treatment of interest and royalties paid between enterprises, enters into force and which may be changed from time to time, then with respect to such interest the provisions of that Directive shall be applicable instead of the provisions of this Article." Article III of the Protocol to the Spain-Switzerland Double Tax Treaty (1966) as amended through 2011: "As regards the application of Article 10, paragraph 2,

departure from the 1998 proposal, which had sought to align the directive's scope with the classifications established under bilateral tax agreements and national tax legislation (see in detail *supra*, A.3.e). Hence, the definition of "royalties" in the IRD should be seen as an autonomous definition.[114] For the relevance of the OECD Commentaries for the interpretation of these notions, we refer to *supra*, A.3.e.

subparagraph b) and of Article 12, paragraph 7, the terms used therein shall be defined according to Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States and Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States."

114 P. Arginelli, 'Open Issues in the Application of the EU Interest- Royalties Directive to Royalty Payments ' in G. Maisto (ed), *Taxation of Intellectual Property under Domestic Law, EU Law and Tax Treaties* (IBFD 2018), 52-55. *See* regarding the autonomous nature of the notions included in the IRD in general: G. Kofler, 'Open Issues in the Application of the EU Interest- Royalties Directive ' in G. Maisto (ed), *Taxation of Interest under Domestic Law, EU Law and Tax Treaties* (IBFD 2022), 61-66.

15

ARTICLE 3: DEFINITION OF COMPANY, ASSOCIATED COMPANY AND PERMANENT ESTABLISHMENT

Christopher (Chris) Thompson

For the purposes of this Directive:

(a) **the term 'company of a Member State' means any company:**
- (i) **taking one of the forms listed in the Annex hereto; and**
- (ii) **which in accordance with the tax laws of a Member State is considered to be resident in that Member State and is not, within the meaning of a Double Taxation Convention on Income concluded with a third state, considered to be resident for tax purposes outside the Community; and**
- (iii) **which is subject to one of the following taxes without being exempt, or to a tax which is identical or substantially similar and which is imposed after the date of entry into force of this Directive in addition to, or in place of, those existing taxes:**

- **impôt des sociétés/vennootschapsbelasting in Belgium,**
- **selskabsskat in Denmark,**
- **Körperschaftsteuer in Germany,**
- **Φόρος εισοδήματος νομικών προσώπων in Greece,**
- **impuesto sobre sociedades in Spain,**
- **impôt sur les sociétés in France,**
- **porez na dobit in Croatia,**
- **corporation tax in Ireland,**
- **imposta sul reddito delle persone giuridiche in Italy,**
- **impôt sur le revenu des collectivités in Luxembourg,**
- **vennootschapsbelasting in the Netherlands,**
- **Körperschaftsteuer in Austria,**
- **imposto sobre o rendimento da pessoas colectivas in Portugal,**
- **yhteisöjen tulovero/inkomstskatten för samfund in Finland,**
- **statlig inkomstskatt in Sweden,**
- **corporation tax in the United Kingdom,**
- **Daň z příjmů právnických osob in the Czech Republic,**
- **Tulumaks in Estonia,**
- **φόρος εισοδήματος in Cyprus,**

- **Uzņēmumu ienākuma nodoklis in Latvia,**
- **Pelno mokestis in Lithuania,**
- **Társasági adó in Hungary,**
- **Taxxa fuq l-income in Malta,**
- **Podatek dochodowy od osób prawnych in Poland,**
- **Davek od dobička pravnih oseb in Slovenia,**
- **Daň z príjmov právnických osôb in Slovakia,**
- **корпоративен данък in Bulgaria,**
- **impozit pe profit, impozitul pe veniturile obținute din România de nerezidenți in Romania;**

(b) **a company is an 'associated company' of a second company if, at least:**
  (i) **the first company has a direct minimum holding of 25 % in the capital of the second company, or**
  (ii) **the second company has a direct minimum holding of 25 % in the capital of the first company, or**
  (iii) **a third company has a direct minimum holding of 25 % both in the capital of the first company and in the capital of the second company.**

Holdings must involve only companies resident in Community territory.

However, Member States shall have the option of replacing the criterion of a minimum holding in the capital with that of a minimum holding of voting rights;

(c) **the term 'permanent establishment' means a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on.**

COMMENTARY

A. INTRODUCTION

15.001 Article 3 helps determine the personal scope of application of the Directive by defining a number of concepts that qualify the source state tax exemption mandated by Article 1.

15.002 As a reminder, Article 1(1) requires that the beneficial owner of the interest or royalties be either a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State. Article 1(3) clarifies that payments covered by the exemption are those made by a company of a Member State or by a permanent establishment situated in another Member State. Finally, Article 1(7) provides that Article 1 only applies if the company which is the payer, or the company whose permanent establishment is treated as the payer, is an associated company of the company which is the beneficial owner, or whose permanent establishment is treated as the beneficial owner, of the relevant interest or royalties.

15.003 On a general level, Article 3 (in the current numbering) was not modified too drastically in the course of the legislative process spanning the 1990 and 1998 Commission proposals. In between those proposals, the Ruding Committee had recommended some sweeping extensions to the original draft's scope, but these were not taken into account (apparently due to budgetary reasons). The 2011 Commission proposal, building on an earlier 2003 proposal which was withdrawn, equally contained more far-reaching changes but has now itself been withdrawn. Where relevant, reference will be made to these various proposals in the following sections.

B. ARTICLE 3(A): COMPANY OF A MEMBER STATE

1. Overview

15.004 The definition of a company of a Member State contained in Article 3(a) is three-pronged.

- Legal form: the company must take one of the forms listed in the Annex;
- Tax residence: the company must be resident for tax purposes in a Member State
- Subject-to-tax requirement: the company must be subject to corporate tax without being exempt.

Those requirements are addressed in the sections below. **15.005**

2. Legal form

The Annex to the Directive (which is reproduced at the end of this chapter) enumerates a number of legal forms per Member State and has been adapted multiple times to address the accession to the EU of new Member States. Indeed, within the system of the Directive, the list is intended to be exhaustive,[1] meaning that the benefits of the Directive are not available to companies or entities having another legal form. **15.006**

A first effect of this approach is that it excludes from the benefit of the Directive companies incorporated outside of the European Union, even if they are resident in an EU Member State.[2] **15.007**

More broadly, the chosen mechanism in theory leaves individual Member States masters of how extensively to apply the principles underpinning the Directive. In an extreme scenario, one could imagine a Member State seeking to only include in the Annex a very rarely used company form, thereby practically opting out of the Directive. This would of course work both ways given the list's general scope of application: the Member State involved would almost never need to relinquish its source state taxation rights, but companies established in that Member State would almost never be able to benefit from the Directive as recipients of cross-border interest or royalties. At the same time, some EU Member States are net importers of capital and know-how whereas others are net exporters, such that their interests are not necessarily aligned. Ultimately though, a balanced outcome appears likely, due to two reasons. Firstly, the Directive and its later updates require mutual agreement and hence negotiation between Member States, each seeking to ensure that they get a fair deal. Secondly, principles of domestic law on non-discrimination in tax matters may lead Member States to reason that if they would in any case risk needing to relinquish their source taxation rights in respect of additional domestic company types, they might as well extend the scope of application of the Directive via the Annex, so that the extension will at least apply in both directions (i.e., not only when the relevant Member State is the source state but also when it is the residence state of the beneficiary). **15.008**

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1 See by analogy Case C-247/08 *Gaz de France* [2009] ECLI:EU:C:2009:600, paras. 32 *et seq*. and the commentary provided under Chapter 4.

2 See the example given in M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 2' (2005) European Taxation, issue 2, 43.

15.009 In terms of the content of the current list, wide variations can be observed. Thus, from a Greek perspective, only one type of company is mentioned (the local equivalent of a public limited company), whereas from a Bulgarian and Hungarian perspective, there are eight in each case. Of course, the number of legal forms existing in each Member State also varies. Moreover, some Member States have included a very open "list", such as Lithuania, which simply refers to companies incorporated under the law of Lithuania, and Italy, whose list concludes with a reference to public and private entities carrying on industrial and commercial activities. This open approach sits well with the Ruding Committee's recommendation – admittedly not followed by the European Commission – that the scope of the Commission's initial 1990 proposal should be extended to all enterprises, irrespective of their legal form.

15.010 In the case of Member States having chosen for a closed enumeration, unanticipated difficulties can arise upon changes to their domestic company law or to other EU tax directives. New company types indeed risk being denied access to the Directive, at the very least temporarily (pending an update of the Annex).

15.011 By way of illustration, given that the 2011 Commission proposal to extend the scope of the Directive in line with the revised scope of the Parent-Subsidiary Directive and the Merger Directive has thus far still not been adopted, the SE and SCE are not included in the list, nor are a number of national legal forms which figure in the Annexes to those other directives (such as, depending on the Member State, cooperatives, mutual companies, certain non-capital based companies, savings banks, funds and associations with commercial activity).

15.012 As regards the SE, it has been argued – in our view convincingly – that this will in many cases be covered by operation of the SE Regulation.[3] Indeed, Article 9.1(c)(ii) of that regulation states that an SE shall be governed, in the case of matters not regulated by the regulation, by the provisions of Member States' laws which would apply to a public limited company formed in accordance with the law of the Member State in which the SE has its registered office. Its

3 N. Herzig and S. Griemla, 'Steuerliche Aspekte der Europäischen Aktiengesellschaft/Societas Europaea (SE)' (2002) Steuer und Wirtschaft, issue 1, 56. This position was also endorsed by J.L. Rodriguez, 'Chapter 8: Commentary on the Interest and Royalties Directive' in in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2004), no. 27; M. Dorr, 'Praxisfragen zur Umsetzung der Zins- und Lizenzrichtlinie in § 50g EStG' (2005) Internationales Steuerrecht, 114; and the 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 (recast) COM(2011) 714 final (11 Nov. 2011), 7.

Article 10 states that, subject to the regulation, an SE shall be treated in every Member State as if it were a public limited liability company formed in accordance with the law of the Member State in which it has its registered office. A similar reasoning applies with respect to the SCE, on the understanding that the Annex to the Directive refers to cooperative companies of Member States in a more limited number of cases compared with public limited companies (see Article 8.1(c)(ii) of the SCE Regulation).

From a source state perspective, a Member State can seek to remediate any coverage issue which arises through a correlative amendment of its domestic tax law. That is, it can unilaterally update the scope of application of the Directive by "extending" it. Any extension should in principle be admissible given that the Directive does not bring about exhaustive harmonisation.[4] Conversely, where income is sourced in a different Member State, the latter is likely to disregard the unilateral action of the Member State of establishment of the beneficiary and only allow the benefit of the Directive to be claimed by company forms included in the Annex as in force at the relevant time. **15.013**

That being stated, the domestic tax legislation of Member States must remain in line with primary EU law.[5] It has been argued that accordingly, if a Member State unilaterally extends the provisions implementing the Directive to entities not listed in the Annex, it risks violating the non-discrimination principle unless it embraces similar types of entities from other Member States.[6] Yet it is worth noting that in the 2009 Commission Report, no caveat was raised to the observation that: "[several Member States] have chosen to extend the benefits of the Directive to payments from a broader range of entities than those listed in the Annex, while maintaining the Annex requirements in respect of the recipients of the payments". Equally, the most recent CJEU case-law confirms that the finding of a violation of the EU freedoms when intra-group interest payments not falling under national implementation of the Directive are subject to source taxation is by no means automatic based on a general comparison of the company type involved with the company types listed in the Annex; instead, it is highly dependent on a detailed comparison of the situation with that of a payment to a resident company (cf. whether resident **15.014**

4 Case C-257/20 Viva Telecom [2022] ECLI:EU:C:2022:125, paras. 45-46.

5 Case C-279/93 Schumacker [1995] ECLI:EU:C:1995:31, para. 21; Case C-446/03 Marks & Spencer [2005] ECLI:EU:C:2005:763, para. 29.

6 J.L. Rodriguez, 'Chapter 8: Commentary on the Interest and Royalties Directive' in in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2004), no. 27, with reference to Case C-168/01 Bosal Holding [2003] ECLI:EU:C:2003:479.

companies receiving interest from another resident company have an obligation to make advance payments of corporation tax, whether they can deduct interest expenditure directly related to the lending at issue, etc.).[7]

15.015 Incidentally, the case-law referenced in the previous paragraph calls into question the historical practice of interposing a qualifying company type to claim the benefits of the Directive in the case of payments made to a similar but non-qualifying company type (think, for example, of the French S.A., which is a qualifying legal form, versus the French S.A.S., which is not). Indeed, leaving aside the complex interactions between the concepts of "beneficial ownership" and "tax abuse" (on which see Chapter 17), it can no longer be asserted with any degree of confidence that such structures should stand up to challenge because they aim to correct a prohibited discrimination.

3. Tax residence

15.016 The second prong of the definition of a company of a Member State requires that it must be resident for tax purposes in a Member State in accordance with the tax laws of that Member State and not considered to be resident for tax purposes outside the EU, under a Double Taxation Convention on Income concluded with a third state.

15.017 The definition of tax residence is thus left, in the first instance, to the tax laws of the Member States, limiting the interference with their tax sovereignty. Nevertheless, from a practical perspective, the leeway of Member States with respect to the personal scope of application of the Directive is limited by the third prong of the definition of a company of a Member State, being the subject-to-tax requirement discussed in the following subsection. There is nothing particularly shocking about this approach, since, as pointed out by J. L. Rodriguez, "residence should be presumed to mean full liability for tax in the Member State concerned, rather than partial liability. Article 4, para. 1 of the OECD Model Convention includes a similar definition of tax residence, and this is the normal understanding of the term".[8]

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7 Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16 N Luxembourg 1 and Others v Skatteministeriet [2019] ECLI:EU:C:2019:134, paras. 85 and 152 (hereafter the 'Danish IRD Cases'), in particular paras. 157 *et seq*.

8 J.L. Rodriguez, 'Chapter 8: Commentary on the Interest and Royalties Directive' in in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2004), nr. 30.

A further limitation is that a company that is considered resident both of a Member State and of a third state under their respective domestic tax laws cannot avail of the Directive if it is considered to be resident of the third state under the tie-breaker rule of the applicable double tax treaty. Due to the varying criteria used to determine tax residence (in particular, place of incorporation, registered office or place of effective management), a company may be considered tax resident in multiple jurisdictions simultaneously. Article 4(3) of the OECD Model Convention traditionally gave priority to the place of effective management in such cases (although it should be noted that, since the 2017 update, the OECD Model leaves it to the contracting states to determine the state of residence by mutual agreement). Where the conflict is settled in favour of a third state, the EU legislator did not wish to grant the company involved the benefit of the Directive, which is understandable given the latter's objectives of supporting the Single Market and ensuring that interest and royalty payments are subject to tax once in a Member State. **15.018**

Cases of dual or multiple residence between EU Member States are in principle not problematic, since Article 3(a) does not require that the three prongs of its definition all be met within a single Member State. The 2009 Commission Report highlighted the fact that some Member States require, as a condition for granting exemption, that the company receiving a payment should be subject to corporation tax in the Member State in which it has its place of effective management. In practice, this is unlikely to unduly deny a company the benefit of the Directive due to the fact that the place of effective management typically serves as the tie-breaker rule in double tax treaties.[9] Moreover, in such cases the company involved will qualify as a company of both Member States where it is considered resident under domestic law and accordingly both Member States will be barred from imposing source taxation on interest or royalties payments by that company.[10] **15.019**

There is, of course, a link to be made with the requirement of Article 1(1) that the interest or royalty payments be cross-border, as further discussed in Chapter 13. Clearly, whilst two companies resident in the same Member State can qualify as a company of a Member State, one will not qualify as a company of "another" Member State to the other. That being stated, the Directive could **15.020**

9 COM (2009) 179 final, Report in accordance with 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, section 3.3.5.3.

10 M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 2' (2005) European Taxation, issue 2, 41.

be extended under domestic law on this point also; in some Member States, such an extension may even be required due to anti-discrimination rules.[11]

15.021 Interestingly, the Directive does not contain any provisions addressing the treatment of hybrid entities, i.e. entities which are considered as tax transparent by a Member State other than that of their tax residence. This is a notable difference with the Parent-Subsidiary Directive (on which see Chapter 6) and the Merger Directive; it has been suggested that the explanation lies in the fact that, contrary to the lists annexed to the two other directives, the Annex has still not been substantially updated and thus covers only "plain vanilla" company types (see the previous subsection).[12] Be that as it may, the Commission considers that there is accordingly no legal basis to look through – and refuse to apply the benefits of the Directive to – a non-resident entity which meets all the requirements of Article 3. Even if a look-through approach were admissible, the Member State should then grant the benefits of the Directive to the hybrid entity's partners/shareholders.[13] For the avoidance of doubt, it is worth noting that the specific rules targeting hybrid mismatches set out in the more recently adopted "ATAD",[14] do in principle, not impact source taxation.

4. Subject-to-tax requirement

15.022 In the first instance, the company must be subject to one of the taxes listed, or to a tax which is identical or substantially similar and which is imposed after the date of entry into force of the Directive in addition to, or in place of, those existing taxes. The taxes listed basically correspond to corporate income tax in the various Member States concerned. The reference to identical or substantially similar future taxes, which constitutes a customary clause in international taxation, should therefore be understood as referring to taxes levied on the income of companies and permanent establishments[15]; this could yet yield

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11 See D. Weber, 'The proposed EC Interest and Royalty Directive' (2000) EC Tax Review, issue 1, 17, footnote 9 and the references cited.

12 A. Cordewener, 'The Interest and Royalties Directive', in P. Wattel et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2019), 630.

13 COM (2009) 179 final, Report in accordance with 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, section 3.3.5.2.

14 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193 of 19 July 2016, as amended by Council Directive (EU) 2017/952 2 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, OJ L 144 of 7 June 2017, 1.

15 J.L. Rodriguez, 'Chapter 8: Commentary on the Interest and Royalties Directive' in in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2004), nr 41.

some interesting discussions in the context of Pillar 2. Contrary to the position under the EU Parent-Subsidiary Directive (on which see Chapter 4) and the Merger Directive, the fact that the company is subject to tax due to the (non-) exercise of an option should not exclude it from the benefit of the Directive.[16]

Separately, whilst no reference is made to a minimum level of taxation as such, the company may not be exempt from tax. Traditionally, subject-to-tax requirements can relate either to the taxpayer (subjective requirement) or to specific income components (objective requirement). In the present case, the wording of Article 3(a), which refers to *the company* being subject to one of the taxes listed, creates the clear impression that one is dealing with a subjective requirement. On the other hand, Recital (3) to the original Directive states that 'It is necessary to ensure that interest and royalty payments are subject to tax once in a Member State', which would tend to point to an objective requirement. Then again, the 2003 and 2011 Commission proposals to amend the Directive included an addition to Article 1(1) that the relevant income must be effectively subject to tax.[17] This shows that at the very least, the current text of the Directive does not unequivocally support the existence of an objective requirement.[18] **15.023**

Ultimately, the CJEU was called upon to rule on the issue. It pointed, firstly, to the fact that the Directive provides for an objective subject-to-tax requirement for PEs, and secondly to the aforementioned objective of the Directive as set out in its Recital (3). On this basis, the CJEU held that a company which benefits from an exemption of the relevant income cannot avail of the Directive.[19] In so doing, the court indirectly validated the approach of a **15.024**

16 K. Eicker and F. Aramini, 'Overview on the Recent Developments of the EC Directive on Withholding Taxes on Royalty and Interest Payments' (2004) EC Tax Review, issue 3, 144; M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 2' (2005) European Taxation, issue 2, 40; 'The proposed EC Interest and Royalty Directive' (2000) EC Tax Review, issue 1, 18; See also L. Cerioni, 'Intra-EC Interest and Royalties Tax Treatment' (2004) European Taxation, 48.

17 Article 1(1) of the 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 (recast) COM(2011) 714 final (11 Nov. 2011); Article 1(1) of the 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 (2003) 841.

18 Understandably, some legal authors even concluded on this basis that the requirement must be interpreted by reference to the tax liability of the company in general – see M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, 144, and in the same vein, G. Kofler, 'Chapter 3 Open Issues in the Application of the EU Interest-Royalties Directive' in G. Maisto (ed), *Taxation of Interest under Domestic Law, EU Law and Tax Treaties* (IBFD 2022), 70-74.

19 Danish IRD Cases, paras. 150 *et seq.* See also Case C-303/07 Aberdeen Property Fininvest Alpha Oy [2009] ECLI:EU:C:2009:377, para. 27, with respect to the Parent-Subsidiary Directive.

number of Member States whose domestic law already specifically required the relevant income to be subject to tax.[20]

15.025 By the same token, a company that is subject to a zero percent tax rate should not be able to invoke the Directive either. Reference can be made in this respect to the decision of the CJEU in the *Wereldhave* case (C-448/15) concerning the Parent-Subsidiary Directive and its requirement that a company should be "subject to [tax], without the possibility of an option or of being exempt" (for a discussion of those cases, see Chapter 4).[21]

15.026 A reduced (non-nil) special tax rate or a reduced (non-nil) taxable basis applicable to interest or royalty payments should, on the other hand, not raise any issues in our view. This follows not only from the fact that the text of the Directive deviates from the 1998 Commission proposal on this point,[22] but more importantly also *a contrario* from the later CJEU case-law cited in the two preceding paragraphs. Of course, the closer to zero the special tax rate or taxable basis, the higher the risk of it being equated to nil.

15.027 Along the same lines of reasoning, the use of losses or tax credits to offset taxable interest income should not exclude beneficial owners from their status as a "company of a member state" either.[23]

15.028 It is worth noting that since the Directive applies to payments between associated companies of a Member State, the above "exclusions" arguably work both ways. That is, if the payor of the income is, for example, subject to a zero percent tax rate (meaning it cannot deduct the income payment), the Directive would not apply irrespective of the fact that the payee may be taxable on the income. In light of the objective of the Directive, this appears to be something of an overreach. The situation of a payor that is generally subject to tax but with the benefit of an exemption for interest or royalties *received*, is less clear. If it is receiving and then on-paying the income, there is clearly an issue (irrespective of beneficial ownership considerations). If it is merely paying the income, one could argue that its qualification as subject to tax, without being

20 COM (2009) 179 final, Report in accordance with 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, section 3.3.5.4.

21 Case C-448/15 Wereldhave Belgium Comm. VA e.a. [2017] ECLI:EU:C:2017:180.

22 Cf. 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 of 4 March 1998, Explanatory Memorandum under 'I. General', para. 18.

23 G. Kofler, 'Chapter 3 Open Issues in the Application of the EU Interest-Royalties Directive' in G. Maisto (ed), *Taxation of Interest under Domestic Law, EU Law and Tax Treaties* (IBFD 2022), 76.

exempt, cannot be influenced by a partial exemption applicable to hypothetical income. Difficult questions equally arise if the receiving company is taxable on certain types of interest income but benefits from an exemption for other types of interest income.[24]

The hope was that the transposition of the Pillar 2 GloBE Model Rules in the EU would help resolve all these issues by acting as a catalyst for the adoption of the Commission's 2011 proposal to amend the Directive, through indirectly mandating a minimum tax rate which would then be applicable to interest and royalty payments.[25] However, events took a slightly different turn, with the Commission recently withdrawing the 2011 proposal on the basis that "the scope of the proposal has been partly taken over by the Directive implementing the OECD Pillar 2 on minimum corporate taxation. The remaining issues the proposal intended to tackle will be addressed via an upcoming Omnibus Act as part of the simplification process".[26] Whilst we should probably pass judgment until adoption of the relevant Omnibus Act, given that the Directive implementing the OECD Pillar 2 on minimum corporate taxation only applies to groups with combined financial revenues of more than €750 million a year and provides for a number of exclusions, safe harbours, and carve-outs, it is difficult to see how this renders the 2011 proposal fully obsolete as regards the subject-to-tax requirement. **15.029**

C. ARTICLE 3(B): ASSOCIATED COMPANY

1. Required link

Pursuant to its Article 1(7), the Directive's personal scope is restricted to associated companies or their permanent establishments (Chapter 13). This represents a significant limitation compared with the unrestricted application between enterprises recommended by the Ruding Committee; nevertheless, it was also instrumental in limiting the immediate budgetary cost of the **15.030**

24 G. Kofler, 'Chapter 3 Open Issues in the Application of the EU Interest-Royalties Directive' in G. Maisto (ed), *Taxation of Interest under Domestic Law, EU Law and Tax Treaties* (IBFD 2022), 76.

25 Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021) 823 final (22 December 2021), Explanatory Memorandum under '1. Context of the proposal'.

26 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – Commission work programme 2025, COM(2025) 45 final (11 February 2025), Annex IV, no. 1.

Directive and hence in gaining support for its adoption (in particular from those Member States that were net importers of capital and know-how).[27]

15.031 The association requirement can be met in various ways:

(i) the first company has a direct minimum holding of 25 % in the capital of the second company, or
(ii) the second company has a direct minimum holding of 25 % in the capital of the first company, or
(iii) a third company has a direct minimum holding of 25 % both in the capital of the first company and in the capital of the second company.

15.032 In other words, the Directive applies to payments from subsidiary to parent, from parent to subsidiary, and between sister companies, as well as their respective PEs.

15.033 Only direct holdings are currently covered, which represents a departure from the 1998 proposal that covered both direct and indirect holdings. That is, the Directive does not apply between grandparent and granddaughter companies, for example. In the absence of another explanation, it has been suggested that this approach was taken for budgetary reasons.[28] Be that as it may, the restriction has been roundly criticised due to its impact on more complex financing structures (e.g. cash pooling centralised by the group finance company).[29] We consider this criticism justified, all the more so since using back-to-back financing arrangements as a workaround in the meantime appears very difficult to defend, in light of the latest CJEU case-law (cf. our comments under Section B.2 regarding the legal form requirement).

15.034 The direct holding requirement creates uncertainty for participations held through or by a partnership which is treated as transparent for tax purposes by the source Member State and/or the residence Member State. One can imagine that some Member States may be inclined to deny the application

27 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 of 4 March 1998, Explanatory Memorandum under 'I. General', para. 14 and 15. See also O. Thömmes, 'The new EC Commission's proposals for Directives on cross-border investments' (1991) Intertax, issue 3, 160.

28 For a detailed discussion, see P. Troiano, 'The EU Interest and Royalty Directive: The Italian Perspective' (2004) Intertax, issue 6-7, 326-327. See also M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, 146; A. Cordewener, 'The Interest and Royalties Directive', in P. Wattel et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2019), 631.

29 M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 2' (2005) European Taxation, issue 2, 41.

of the Directive in such circumstances.[30] The 2009 Commission Report is silent on the matter. With regard to the definition of a company, as already discussed, the report states that the Directive does not allow Member States to look through non-resident qualifying entities. By the same token, one could invoke the fact that the Directive does not specifically allow Member States to look through non-qualifying entities either. Yet, on a more positive note, the report also refers to the logic of a look-through approach and to the OECD Partnership Report and the Commentary on Article 1 of the Model Tax Convention, to state that a Member State must under such an approach apply the benefits of the Directive to the partner/shareholder.[31] In our view, this should also apply as far as the direct holding requirement is concerned.

The concept of "capital" is not defined by the Directive. This would at first sight suggest that it could cover the legal capital or all equity accounts, including all reserves. On the other hand, consideration of EU law applicable in other areas, in particular the (then in force) Second Council Directive 77/91/EEC and the Fourth Council Directive 78/990/EEC, has led some authors to conclude that the Directive refers to legal capital.[32] From our side, given the interplay between the Directive and the Parent-Subsidiary Directive, as well as the use of the same terminology in both directives with respect to the minimum holding requirement, we refer to the detailed discussion under (Chapter 4).[33] **15.035**

Nevertheless, it is worth noting that given the threshold under the Parent-Subsidiary Directive has in the meantime been lowered to 10%, some **15.036**

30 M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, 146; R. Russo, 'Partnerships and other hybrid entities and the EC Corporate Direct Tax Directives' (2006) European Taxation 2006, issue 10, 480.

31 COM (2009) 179 final, Report in accordance with 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, section 3.3.5.2.

32 J.L. Rodriguez, 'Chapter 8: Commentary on the Interest and Royalties Directive' in in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2004), nr. 63-65.

33 See also the contrasting positions taken by, on the one hand: J. Bundgaard, 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 2' (2010) European Taxation, issue 11, 496, according to which hybrid financial instruments do not constitute equity capital under the directives; and on the other hand: M. Helminen, *The Dividend Concept in international Tax Law* (Kluwer 1999), 267; E. Eberhartinger and M. 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' (2006) WU Vienna University of Economics and Business. Discussion Papers SFB International Tax Coordination No. 16, https://research.wu.ac.at/ws/portalfiles/portal/19841998/document.pdf (last consulted on 14 January 2025), 22-23.

surprising results may arise. One example involves an interest or royalty payment by a 20% subsidiary which is not exempt under the Directive but may be exempt under the Parent-Subsidiary Directive if it is reclassified as a profit distribution.[34] Even more surprises can lie in store if one takes into account the fact that treating additional instruments (e.g. profit participating certificates) as representative of capital should logically work both ways; it may open up the entitlement of the additional investor to the Directive and/or the Parent-Subsidiary Directive, but must by the same token dilute the holding of the plain vanilla shareholders, potentially depriving them of the benefit of the Directive and/or the Parent-Subsidiary Directive. Let us assume a company with four shareholders each holding 25% of its legal capital of 100 and who are also lenders to the company. Potentially, these shareholder-lenders can all qualify for the benefit of the Directive. However, if we also assume an additional investment of 35 in an alternative instrument considered as equity by a third party which is also a lender, none of the initial four shareholder-lenders will be able to qualify for the benefit of the Directive anymore (since their participation will be reduced to 25/(100+35) = 18.5%), whereas the new equity investor and lender will hold (35/(100+35) = 25,9%).[35]

15.037 Perhaps due to all these uncertainties having been anticipated, the Directive gives Member States the option to apply the 25% thresholds mentioned to voting rights as an *alternative* to capital participations. In other words, Member States can either replace the reference to capital participations with a reference to voting rights, or provide an alternative reference to capital participations or voting rights. They may, on the other hand, not require that both criteria be fulfilled simultaneously.[36]

15.038 If one takes into account the existence in some legal systems of shares with multiple voting rights as well as non-voting shares, referring to voting rights rather than capital participation would appear to give rise to quite some possibilities of arbitrage. This applies all the more if a legal system grants companies flexibility in terms of the majority necessary for the approval of certain types

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34 A. Cordewener, 'The Interest and Royalties Directive', in P. Wattel et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2019), 632.

35 For another somewhat similar example based on the Belgian implementation of the Parent-Subsidiary Directive, see C. Cheruy and C. Laurent, *Le regime fiscal des sociétés Holdings en Belgique* (Larcier 2008), 331, nr. 562.

36 COM (2009) 179 final, Report in accordance with 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, section 3.3.6.1; A. Cordewener, 'The Interest and Royalties Directive', in P. Wattel et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2019), 632.

of decisions and/or in terms of the respective rights of multiple share classes. At the same time, there will necessarily be some cases where the reference to voting rights instead of capital participations would prevent companies from qualifying as associated.

The 2011 Commission proposal would have reduced the direct 25% shareholding threshold to a direct or indirect 10% shareholding threshold. Given the proposal's recent withdrawal, we will have to see to what extent this change is included in the announced Omnibus Act (cf. above in relation to the subject-to-tax requirement). **15.039**

Finally, the holdings must involve only EU-resident companies. In the view of the Commission, which we share, this means that in the case of sister companies, their common parent must be EU-resident as well; other authors take a different position, under which the concept of holding only applies in respect of the participation.[37] In any event, Member States may be more generous than the Directive and waive the requirement.[38] **15.040**

2. Minimum holding period

Pursuant to Article 1(10), a Member State may opt not to apply the Directive if the required holding has not been maintained for an uninterrupted period of at least two years. **15.041**

This appears to be a specific anti-abuse measure aimed at avoiding companies fulfilling the minimum holding requirement only just around the time of an interest or royalty payment. Some authors have questioned whether it was really needed given the general authorisation in Article 5 of domestic or agreement-based provisions to combat fraud or abuse,[39] but one could equally make the case that the minimum holding period has merit as a semi-harmonised measure decreasing the need for such further *ad hoc* measures. Along the same line of thought, other authors have even taken the position that the existence of the option precludes a Member State from relying on a general anti-abuse **15.042**

37 For a more detailed discussion of this hotly debated issue, see M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, 146; M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 3' (2005) European Taxation, issue 3, 95 and the references cited.

38 COM (2009) 179 final, Report in accordance with 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, section 3.3.6.2.

39 J.L. Rodriguez, 'Chapter 8: Commentary on the Interest and Royalties Directive' in in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2004), nr. 70.

clause focused on the holding period, either as an alternative to the option or to supplement it.[40] In any case, the 2009 Commission Report identified 11 out of 20 Member States surveyed as having availed themselves of the option.[41]

15.043 Article 3(2) of the Parent-Subsidiary Directive contains a similar option, except that it refers to the case where the required holding "is not maintained" (in the present tense). In the *Denkavit* case (C-283/94), the CJEU took into consideration the fact that most language versions of that provision used the present tense, in order to conclude that it is not necessary for the period to have been completed at the time the tax advantage is granted.[42] There could therefore be a concern that the linguistic difference with Article 1(10) of the Directive may result in a different analysis in the latter's case. At the time of the 2009 Commission Report, three of the Member States surveyed required the holding period to have elapsed at the time of payment, with no possibility for a subsequent fulfilment to be taken into account retroactively.[43]

15.044 However, the present tense was already used in the 1998 Commission Proposal, which was accompanied by an Explanatory Memorandum stating that Member States may not "make the granting of the tax advantage provided for by the Directive subject to the condition that, at the moment of the payment of the interest and royalties, this holding period has already been completed, so long as it is subsequently observed".[44]

15.045 The issue should be completely settled if one considers that not all language versions of the Directive use the past tense. Moreover, when ruling on the Parent-Subsidiary Directive, the CJEU also had regard to the directive's purpose and to the fact that the option to lay down a minimum holding period should be interpreted strictly as it constituted a derogation from the general

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40 A. Cordewener, 'The Interest and Royalties Directive', in P. Wattel et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2019), 633.

41 COM (2009) 179 final, Report in accordance with 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, section 3.3.3.

42 Joined cases C-283/94, C-291/94 and C-292/94 Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen [1996] ECLI:EU:C:1996:387.

43 COM (2009) 179 final, Report in accordance with 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, section 3.3.3.

44 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 of 4 March 1998, Article 3(2).

principle of exemption. These other arguments appear transposable to the case of the Directive.[45]

In fact, in its 2009 report, the Commission took a step further by suggesting that in light of the entry into force of the directive on mutual assistance in the recovery of tax claims, Member States may no longer be entitled to require security for the source tax during the remainder of the holding period (if applicable).[46] In fact, we consider that this position is perfectly in line with the CJEU's later case-law.[47] **15.046**

Finally, we wish to dwell for a moment on the interaction between the Directive and the Merger Directive. In our view, just like for the optional holding period provided for by the Parent-Subsidiary Directive (see Chapter 4), there are sound arguments to the effect that the holding period of the pre-reorganisation holder of the relevant participation can be continued by its post-reorganisation holder, assuming the other conditions for eligibility remain fulfilled (cf. required level of participation or voting rights, qualifying company form, tax residence within the EU and subject-to-tax requirement). In particular, in line with the position of A. Cordewener, we consider as decisive the object and purpose of the Directive and the CJEU's narrow interpretation of the anti-abuse provision in the Merger Directive. We equally agree that since the option refers to the conditions in Article 3(b) collectively, the holding period should not be interrupted in the case of a change from one qualifying holding relationship to another (e.g. if a company becomes a subsidiary of its former sister or vice versa).[48] **15.047**

D. ARTICLE 3(C): PERMANENT ESTABLISHMENT

Article 3(c) defines a permanent establishment as a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on. **15.048**

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45 M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, 151; K. Eicker and F. Aramini, 'Overview on the Recent Developments of the EC Directive on Withholding Taxes on Royalty and Interest Payments' (2004) EC Tax Review, issue 3, 142-143. See, in the same vein, the Opinion of AG Sharpston in Case-397/09 Scheuten Solar Technology GmbH [2011] ECLI:EU:C:2011:292, para. 91.

46 COM (2009) 179 final, Report in accordance with 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, section 3.3.3.

47 See e.g. Case C-371/10, National Grid Indus BV [2011] ECLI:EU:C:2011:785.

48 A. Cordewener, 'The Interest and Royalties Directive', in P. Wattel et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2019), 633.

15.049 This definition is just as critical as the previous ones to the system of the Directive, as evidenced by the numerous references to it in the substantive provisions of Article 1 – these are discussed in more detail mainly in Chapter 13:

- The exemption from source taxation of Article 1(1) in respect of interest or royalty payments arising in a Member State also applies when the beneficial owner of the interest or royalties is a permanent establishment situated in another Member State of a company in a Member State;
- Article 1(2) provides that a payment shall be deemed to arise in a Member State, amongst other cases, when it is made by a permanent establishment situated therein, and Article 1(3) clarifies that a permanent establishment shall be treated as the payer of interest or royalties only insofar as those payments represent a tax-deductible expense for the permanent establishment in the Member State in which it is situated;
- Article 1(5) defines the conditions subject to which a permanent establishment is to be treated as the beneficial owner of interest or royalties, which differ somewhat from the conditions applicable to a company of a Member State;
- Article 1(6) provides that where a permanent establishment of a company of a Member State is treated as the payer, or as the beneficial owner, of interest or royalties, no other part of the company shall be treated as the payer, or as the beneficial owner, of that interest or those royalties;
- Article 1(7) contains the associated company requirement already discussed earlier in this chapter, in accordance with which any PE which is the payee or payor of interest or royalties needs to belong to an associated company of the counterparty for the Directive to apply. The option of a minimum holding period of Article 1(10) remains relevant in this context.
- Article 1(8) excludes from the benefit of the Directive cases where interest or royalties are paid by or to a permanent establishment situated in a third State of a company of a Member State and the business of the company is wholly or partly carried on through that permanent establishment;
- Finally, Article 1(9) makes clear that the Directive does not prevent a Member State from taking interest or royalties received by its companies, by permanent establishments of its companies or by permanent establishments situated in that State into account when applying its tax law.

15.050 Separately, the procedural requirements of Article 1 apply *mutatis mutandis* for permanent establishments.

15.051 To return to the definition, a first point of note is that it requires both the head office and the PE to be in Member States. In other words, a permanent establishment under domestic law or double tax treaty definitions will, in any case not qualify as a permanent establishment for the purposes of the Directive if it belongs to a third country company or is located in a third country state.

The next logical question is the extent to which the definition of permanent establishment for the purposes of the Directive involves any specificities with respect to the OECD Model definition (this book is not the place to cover differences between the latter and various domestic laws). **15.052**

In substance, the definition of the Directive follows that of Article 5(1) of the OECD Model, which relates to a so-called fixed place of business. It does not, however, comprise any equivalent to the following paragraphs of Article 5 of the OECD Model. **15.053**

As far as Article 5(2) of the OECD Model is concerned, this should not give rise to any particular issues since it is considered to contain a non-exhaustive list of illustrative examples of fixed places of business. **15.054**

The situation is more complex when it comes to Articles 5(3) and 5(5) of the OECD Model. A building site or construction or installation project lasting more than 12 months, or in particular a dependent agent acting on behalf of the company and having authority to conclude contracts in its name, does not constitute fixed places of business. At first sight, they should therefore not qualify as a permanent establishment under the Directive. However, this would seem at odds with the rationale of the Directive, as well as the CJEU's Saint-Gobain case-law,[49] since agency PEs and subsidiaries would then be treated differently.[50] Of course, in the absence of a permanent establishment, it is by default (in line with the logic of Article 1(6)) the head office which should be considered as the payer or payee of the interest or royalties for the purposes of the Directive, meaning that the latter can as such still apply.[51] In our view, this should indeed be the case where the PE discussion affects the payee, since the beneficial ownership requirements for (the head office of) a company of a Member State are less stringent than those for a permanent establishment. On the other hand, a PE discussion affecting the payor risks in practice depriving the taxpayer of the benefits of the Directive: only the Member State of the head office would be prohibited from levying source taxation on interest or royalty payments, not the other Member State where the company has a permanent establishment under the applicable double tax treaty and which is likely to be the one seeking to levy source taxation in line with that treaty. **15.055**

49 Case C-307/97 Compagnie de Saint-Gobain [1999] ECLI:EU:C:1999:438.

50 M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 2' (2005) European Taxation, issue 2, 42.

51 J.L. Rodriguez, 'Chapter 8: Commentary on the Interest and Royalties Directive' in in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2004), nr 94.

15.056 Article 5(6) OECD Model excludes from the so-called "agency permanent establishment" the case of a broker, general commission agent, or any other agent of independent status. If one takes the position that the Directive's definition of permanent establishment in fact aligns with the (full) OECD Model one, this raises no issues. And even if one takes the opposite view, clearly no exclusion is needed if an agency permanent establishment does not qualify as a permanent establishment under the Directive in the first place.

15.057 Equally, activities of a preparatory or auxiliary character are excluded from the definition of a fixed place of business by Article 5(4) of the OECD Model. Again, even if one were to take the position that the Directive's definition of permanent establishment does not align with the OECD Model, there should be no practical impact due to other provisions of the Directive. Indeed, as raised by J. L. Rodriguez:

- Under Article 1(3) of the Directive, a permanent establishment shall be treated as the payer of interest or royalties only insofar as those payments represent a tax-deductible expense for the permanent establishment in the Member State in which it is situated. In the absence of a permanent establishment under the applicable double tax treaty, there should be no tax-deductible expenses in the relevant Member State;
- Under Article 1(5) of the Directive, a permanent establishment shall be treated as the beneficial owner of interest or royalties only if the interest or royalty payments represent income in respect of which that permanent establishment is subject to tax in the Member State in which it is situated. In the absence of a permanent establishment under the applicable double tax treaty, any nexus with a Member State should not trigger tax there.[52]

15.058 In its 2009 report, the Commission ultimately concluded that: "The fact that the Directive's definition differs somewhat from that of Article 2(2) of the Parent-Subsidiary Directive, and that neither definition reproduces exactly Article 5 of the OECD [Model], may create a situation of legal uncertainty, in particular concerning the situation of dependent agent PEs". Yet it also highlighted that most Member States had chosen to rely on their general domestic law definition of a PE when implementing the Directive, with only five having introduced a specific definition for this purpose.[53]

52 J.L. Rodriguez, 'Chapter 8: Commentary on the Interest and Royalties Directive' in in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law: commentary on the EC direct tax measures and member states implementation* (IBFD, loose-leaf, 2004), nr. 96.

53 COM (2009) 179 final, Report in accordance with 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, section 3.3.7.

Although one cannot deny the existence of a level of legal uncertainty until the matter is finally resolved either by an amendment to the Directive or by a decision of the CJEU, we are cautiously optimistic, encouraged by the decisions which the court has in the meantime issued in the so-called Danish cases and specifically its references therein to the OECD principles combined with the legislative history of the Directive.[54] We would thus tend to agree that if called upon to interpret the term "permanent establishment", the CJEU will in all likelihood base itself on the whole of Article 5 of the OECD Model.[55] **15.059**

Of course, an additional layer of difficulty results from the fact that there may also be some cases where a double tax treaty between two Member States deviates from the OECD Model on this point. In such a case, we would fully expect the CJEU to give preference to the OECD Model for the interpretation of the Directive, since the latter's scope cannot be altered by bilateral double tax treaties between Member States. **15.060**

As a closing remark for the sake of completeness, we note that the difference between the PE definition in the Interest & Royalty Directive and that in the Parent-Subsidiary Directive is essentially optical. Indeed, the shorter definition in the Interest & Royalty Directive should be read in conjunction with the beneficial ownership requirement in its Article 1(5), leading to a very similar end result to that of the Parent-Subsidiary Directive, which does not contain a separate beneficial ownership requirement. We refer to Chapter 4 for further details in this respect. **15.061**

E. CONCLUSION

To sum up, commenting on Article 3 has shone a light on a number of shortcomings in the Directive's scope – e.g. the not fully coherent list of covered company forms, the limitation to associated companies, and the lack of clarity in the definitions of capital and permanent establishment. Admittedly, in certain Member States (e.g. Germany and Ireland), the scope of withholding tax under domestic law is so limited, or the scope of exemptions under domestic law so broad, that the Directive currently has little practical relevance. For Member States where the Directive goes significantly beyond domestic law, **15.062**

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54 Danish IRD Cases. For a more detailed (and critical) discussion of the CJEU's approach, see G. Kofler, 'Chapter 3 Open Issues in the Application of the EU Interest-Royalties Directive' in G. Maisto (ed), *Taxation of Interest under Domestic Law, EU Law and Tax Treaties* (IBFD 2022), 63-66.

55 A. Cordewener, 'The Interest and Royalties Directive', in P. Wattel et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2019), 634.

the identified shortcomings have, of course, been there from the start, due to the compromise nature of a text which was originally intended as a mere first step. Nevertheless, we believe that from a practical perspective, they have come into starker focus over the past 5 years, following the CJEU's decision in the Danish cases, which have created significant uncertainty around structures put in place to sidestep the aforementioned shortcomings. We would therefore venture that in future, pressure to update the Directive will only grow, and that failing any movement from that perspective, the level of practical harmonisation brought about by the Directive will actually recede. Following the recent withdrawal of the Commission's 2011 Proposal, it is therefore crucial that the issues it intended to tackle be effectively addressed via an Omnibus Act in the short term.

ANNEX

List of companies covered by Article 3(a) of the Directive

(a) **Companies under Belgian law known as: 'naamloze vennootschap/société anonyme, commanditaire vennootschap op aandelen/société en commandite par actions, besloten vennootschap met beperkte aansprakelijkheid/société privée à responsabilité limitée' and those public law bodies that operate under private law;**

(aa) **companies under Bulgarian law known as: 'събирателното дружество', 'командитното дружество', 'дружеството с ограничена отговорно ст', 'акционерното дружество', 'командитното дружество с акции', 'кооперации', 'кооперативни съюзи', 'държавни предприятия' constituted under Bulgarian law and carrying on commercial activities;**

(ab) **companies under Romanian law known as: 'societăți pe acțiuni', 'societăți în comandită pe acțiuni', 'societăți cu răspundere limitată';**

(b) **companies under Danish law known as: 'aktieselskab' and 'anpartsselskab';**

(c) **companies under German law known as: 'Aktiengesellschaft, Kommanditgesellschaft auf Aktien, Gesellschaft mit beschränkter Haftung' and 'bergrechtliche Gewerkschaft';**

(d) **companies under Greek law known as: 'ανώνυμη εταιρία';**

(e) **companies under Spanish law known as: 'sociedad anónima, sociedad comanditaria por acciones, sociedad de responsabilidad limitada' and those public law bodies which operate under private law;**

(f) **companies under French law known as: 'société anonyme, société en commandite par actions, société à responsabilité limitée' and industrial and commercial public establishments and undertakings;**

(g) **companies in Irish law known as public companies limited by shares or by guarantee, private companies limited by shares or by guarantee, bodies registered under the Industrial and Provident Societies Acts or building societies registered under the Building Societies Acts;**

(h) **companies under Italian law known as: 'società per azioni, società in accomandita per azioni, società a responsabilità limitata' and public and private entities carrying on industrial and commercial activities;**
(i) **companies under Luxembourg law known as: 'société anonyme, société en commandite par actions and société à responsabilité limitée';**
(j) **companies under Dutch law known as: 'naamloze vennootschap' and 'besloten vennootschap met beperkte aansprakelijkheid';**
(k) **companies under Austrian law known as: 'Aktiengesellschaft' and 'Gesellschaft mit beschränkter Haftung';**
(l) **commercial companies or civil law companies having a commercial form, cooperatives and public undertakings incorporated in accordance with Portuguese law;**
(m) **companies under Finnish law known as: 'osakeyhtiö/aktiebolag,osuuskunta/andelslag, säästöpankki/sparbank' and 'vakuutusyhtiö/försäkringsbolag';**
(n) **companies under Swedish law known as: 'aktiebolag' and 'försäkringsaktiebolag';**
(o) **companies incorporated under the law of the United Kingdom;**
(p) **companies under Czech law known as: 'akciová společnost', 'společnost s ručením omezeným', 'veřejná obchodní společnost', 'komanditní společnost', 'družstvo';**
(q) **companies under Estonian law known as: 'täisühing', 'usaldusühing', 'osaühing', 'aktsiaselts', 'tulundusühistu';**
(r) **companies under Cypriot law known as: companies in accordance with the Company's Law, Public Corporate Bodies as well as any other Body which is considered as a company in accordance with the Income tax Laws;**
(s) **companies under Latvian law known as: 'akciju sabiedrība', 'sabiedrība ar ierobežotu atbildību';**
(t) **companies incorporated under the law of Lithuania;**
(u) **companies under Hungarian law known as: 'közkereseti társaság', 'betéti társaság', 'közös vállalat', 'korlátolt felelősségű társaság', 'részvénytársaság', 'egyesülés', 'közhasznú társaság', 'szövetkezet';**
(v) **companies under Maltese law known as: 'Kumpaniji ta' Responsabilita' Limitata', 'Soċjetajiet in akkomandita li l-kapital tagħhom maqsum f'azzjonijiet';**
(w) **companies under Polish law known as: 'spółka akcyjna', 'spółka z ograniczoną odpowiedzialnością';**
(x) **companies under Slovenian law known as: 'delniška družba', 'komanditna delniška družba', 'komanditna družba', 'družba z omejeno odgovornostjo', 'družba z neomejeno odgovornostjo';**
(y) **companies under Slovak law known as: 'akciová spoločnos', 'spoločnosť s ručením obmedzeným', 'komanditná spoločnos', 'verejná obchodná spoločnos', 'družstvo';**
(z) **companies under Croatian law known as: 'dioničko društvo', 'društvo s ograničenom odgovornošću', and other companies constituted under Croatian law subject to Croatian profit tax.**

16

ARTICLE 4: EXCLUSION OF PAYMENTS AS INTEREST OR ROYALTIES

Niels Bammens

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.**
2. **Where, by reason of a special relationship between the payer and the beneficial owner of interest or royalties, or between one of them and some other person, the amount of the interest or royalties exceeds the amount which would have been agreed by the payer and the beneficial owner in the absence of such a relationship, the provisions of this Directive shall apply only to the latter amount, if any.**

COMMENTARY

A. INTRODUCTION

Article 4 addresses situations in which the Directive does not apply. The first paragraph allows for the optional exclusion of certain categories of payments. Broadly speaking, it concerns payments with some characteristics that are not typical of interest or royalty payments. For that reason, Member States may prefer to exclude such payments from the benefits of the Directive. The second paragraph provides for the compulsory exclusion of interest and royalty payments that are not at arm's length. **16.001**

Article 4 should be read against the backdrop of the definition of interest and royalties in Article 2 of the Directive. As discussed in Chapter 14, that definition is fairly broad. However, Article 4 allows for the material scope of application of the Directive to be narrowed by providing for situations to which the Directive does not apply (either optionally or compulsorily). Because a number of those exclusions are optional, the result is that Member States have some leeway in defining the Directive's material scope of application. **16.002**

The sections below address both paragraphs in detail. For completeness' sake, it should be noted that the 1990 Commission proposal did not include a provision dealing with these issues.[1] The 1998 Commission proposal contained wording that is similar to the current Article 4, but in two separate articles: an optional exclusion similar to the current Article 4(1) was included as Article 4, while a compulsory exclusion similar to the current Article 4(2) was included as Article 5.[2] **16.003**

B. ARTICLE 4(1): OPTIONAL EXCLUSION

1. General remarks

Article 4(1) seeks to prevent the benefits of the Directive from being granted in certain situations where that would not be appropriate in light of the **16.004**

1 Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, COM(90) 571 final of 28 November 1990, O.J. 1991 C 53/26.

2 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 of 4 March 1998, O.J. 1998 C 123/9.

Directive's objective. In particular, the provision allows Member States to disallow the benefits of the Directive if a payment formally qualifies as an interest or royalty payment but has features that, in substance, reveal a different nature. While such discrepancies may occur in a variety of situations, it is mainly relevant in the context of corporate financing.

16.005 Generally speaking, companies can be financed through either debt or equity (or, as is commonly the case in practice, through a combination of both). While the distinction is not always entirely clear in practice, there is broad agreement on a number of features that are characteristic of each category. Debt financing is typically granted for a set period of time, with the funds provided generating interest (for instance calculated at a fixed percentage of the principal) and a requirement to repay the principal amount irrespective of the company's profitability. Debt-claims are typically not subject to the company's business risks. Equity financing, by contrast, is typically granted for an indefinite period of time, with voting rights attaching to the capital. Equity providers are generally granted ownership in the company, and their investment is in principle subject to the company's business risks, without any guarantee of repayment and dividend distributions depending on the company's financial performance.

16.006 The distinction between debt and equity has important tax consequences. Under most tax systems, interest payments constitute deductible expenses for the borrower, while dividend distributions are generally not tax-deductible. From the perspective of the recipient, interest payments are generally taxable, while dividends are often subject to preferential tax treatment to prevent or alleviate double taxation, particularly in an inter-company context. That difference in tax treatment may affect financing strategies. For instance, companies may prefer debt financing over equity financing due to the deductibility of interest. Because that debt bias may negatively affect companies' solvency as well as a country's tax base, many domestic tax systems contain mechanisms to curb excessively tax-driven financing strategies (such as thin capitalisation rules that disallow the deductibility of interest when a company's level of debt is disproportionate to its equity capital).

16.007 In addition, the features of debt and equity are fairly clear from a theoretical perspective, but financial practice has given rise to investments that are difficult to classify because they have features of both debt and equity. For instance, an investment may have debt-like features such as an entitlement to a repayment of the principal, but also equity-like features such as the potential for profit participation. These instruments are generally referred to as hybrid financial instruments, i.e., financial instruments that have economic characteristics that are inconsistent, in whole or in part, with the classification implied by their legal form.[3] While there are often valid business reasons to use such instruments, they may also be used for tax reasons, particularly in cross-border situations. For instance, it may be attractive from a tax perspective to use financing that qualifies as debt for purposes of the domestic laws of the source state (so that the company making the payment is entitled to a deduction) but as equity for purposes of the investor's home state (so that the investor is entitled to the tax benefits granted to dividends).

Article 4 of the Directive recognises these concerns, and permits Member States to disallow the Directive's benefits if a payment has features that render it incommensurable with an actual interest (or royalty) payment. In particular, Article 4 refers to payments which are treated as a distribution of profits or as a repayment of capital under the law of the source State (see section 2.2 below); payments from debt-claims which carry a right to participate in the debtor's profits (see section 2.3 below); payments from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits (see section 2.4 below); and 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 (see section 2.5 below). **16.008**

Before discussing the different exclusions in Article 4(1) of the Directive, it may be useful to point out that they all refer to 'payments'. In its 2022 decision in the *Viva Telecom Bulgaria* case, the Court of Justice clarified that the use of that concept implies that an actual payment must be made for Article 4(1) to apply, so that notional interest is not covered by the provision. The case concerned a Bulgarian domestic rule under which a resident company that has been granted an interest-free loan by its non-resident parent company is liable to withholding tax on notional interest (at the rate that would apply under normal market conditions). The Court held that Article 4(1) of the Directive was not applicable because no actual payment had been made: **16.009**

> notional interest set by the tax authorities, such as that at issue in the main proceedings, cannot be regarded as interest payments for the purposes of Article 1(1) and Article 2(a) of Directive 2003/49, precisely since no payment has been made.
>
> For the same reason, such interest cannot be covered by Article 4(1)(d) of that directive either, given that that provision relates to 'payments' from debt-claims [. . .].[4]

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3 J. Duncan, 'General report', in in IFA, *Cahiers de Droit Fiscal International - Vol. 85a: Tax treatment of hybrid financial instruments in cross-border transactions* (Kluwer 2000), 22.

4 Case C-257/20 Viva Telecom Bulgaria [2022] ECLI:EU:C:2022:125, para. 55-56. For a critical analysis, see S. Kostikidis and F. Striefler, 'Fictitious Interest and Dividends Under Tax Treaties and the EU

16.010 Another preliminary remark is that Article 4(1)(b), (c) and (d) allow the source state to deny the withholding tax exemption under the Directive even though the payments retain their character as interest. It has been argued that this can be explained on the basis that the Directive assumes that the payments referred to in Article 4(1)(b), (c) and (d) qualify as profit distributions so that a hybrid mismatch is created. That is to say, the Directive appears to assume that these payments give rise to a tax deduction for interest in the source state while granting entitlement to an exemption (as a dividend) in the recipient's home state.[5] Support for that interpretation may perhaps be found in the third recital of the Directive's preamble, which states that 'It is necessary to ensure that interest and royalty payments are subject to tax once in a Member State'. However, even if that assumption appears reasonable, it should be noted that the design of these provisions is not entirely suitable to achieve that objective. Indeed, these provisions do not refer to the tax treatment of the payments in the recipient's home state, so that it cannot be excluded that the source state denies the exemption to a payment that qualifies as interest in the recipient's home state as well (thus likely creating double taxation).[6]

16.011 A final preliminary remark concerns the historical background of Article 4 of the Directive. As noted above, the 1998 Commission proposal included a provision similar to the current Article 4. That provision read as follows:

16.012 By way of derogation from the provisions of Article 2(1)(a) and (2), the Member State where the interest arises may exclude from the application of this Directive payments purporting to be interest such as any of the following:

(a) income which is treated as a distribution of profits or as a repayment of capital;
(b) income from debt-claims which carry a right to participate in the payer's profits;
(c) income from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the payer's profits;
(d) income from debt-claims which contain no provision for repayment of the principal amount.

Directives' (2022) EC Tax Review, issue 5, 255.

5 M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, issue 4, 150.

6 E. Eberhartinger and M. Six, 'Taxation of cross-border hybrid finance: a legal analysis' (2009) Intertax, issue 1, 16. Compare J. Bundgaard, 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1' (2010) European Taxation, issue 10, 446.

Interest that has been re-characterised as a distribution of profits shall accordingly be subject instead to the provisions of Council Directive 90/435/EEC (1), where it is paid between companies to which the present Directive applies. **16.013**

Interestingly, Article 4 of the 1998 proposal did not cover royalty payments but only 'payments purporting to be interest'. By contrast, the current version broadly refers to 'payments', and its title mentions both interest and royalties. While it is true that the current version is mainly relevant for interest payments, it is nevertheless important to point out that it may also be applied to royalties (for instance, in the case of profit-based royalty payments). **16.014**

The explanatory memorandum to the 1998 proposal is fairly brief on the reasoning behind the proposal. It simply states that: **16.015**

> 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.[7]

The wording of Article 4 of the 1998 proposal gave rise to some criticism, which may have contributed to its redrafting in the version that was ultimately approved. Most notably, it was argued that the reference to 'payments purporting to be interest' necessitated the proof of individual intentions, which would be difficult in practice. In addition, the list of cases in Article 4 of the 1998 proposal appeared to be merely illustrative in nature ('such as'), which could result in interpretation issues.[8] By contrast, the current version of Article 4(1) contains an exhaustive list of optional exclusions. **16.016**

Another difference between the 1998 proposal and the current version of the Directive is that Article 4 of the 1998 proposal expressly provided that 'interest that has been re-characterised as a distribution of profits shall accordingly be subject instead to the provisions of [the Parent-Subsidiary Directive]'. No such statement is included in the current version of Article 4. On the possibility of **16.017**

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7 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, Explanatory memorandum, COM(1998) 67 final, 98/0087, 8.

8 Report on the 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(98)0067 - C4-0195/98 - 98/0087(CNS).

applying the Parent-Subsidiary Directive to such 're-characterised' payments, reference is made to Chapter 2.

2. Payments treated as a profit distribution or as a repayment of capital

16.018 The first optional exclusion concerns 'payments which are treated as a distribution of profits or as a repayment of capital under the laws of the source State'. The applicability of this exclusion therefore depends entirely on the domestic law of the source state: any payment that is treated as a profit distribution or a repayment of capital under those laws is liable to trigger the optional exclusion.

16.019 In contrast to the compulsory exclusion of Article 4(2) (see section 3 below), it is not required that there is a special relationship between the parties involved in the transaction. Moreover, there is no requirement of tax-driven motives or the intention to engage in tax avoidance. As a result, the exclusion may also apply to domestic measures that characterise an interest payment as a dividend on the basis of a fixed threshold, irrespective of intentions or motives. A typical example is a domestic thin capitalisation rule that classifies interest as a dividend insofar as a fixed debt/equity ratio is exceeded. Article 4(1)(a) therefore allows the source state to deny the benefits of the Directive to the portion of the payment that is characterised as a dividend (i.e., the portion of the interest that corresponds to the excessive part of the loan) under its domestic laws. For completeness' sake, it should be noted that the Court of Justice has ruled on the compatibility of such thin capitalisation rules with the free movement provisions.[9]

16.020 In addition, this exclusion could also be relevant for domestic measures that seek to challenge tax arbitrage with hybrid financial instruments by treating interest as a profit distribution if the recipient's home state classifies the instrument as equity.[10]

3. Profit-participating debt-claims

16.021 Article 4(1)(b) provides that the source state is not required to grant the benefits of the Directive in the case of 'payments from debt-claims which carry a right to participate in the debtor's profits'. In order for this provision to apply, a debt-claim must exist. Reference is made to Chapter 14 for further discussion of that concept.

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9 E.g. Case C-324/00 Lankhorst-Hohorst GmbH [2002] ECLI:EU:C:2002:749.

10 J. Bundgaard, 'Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1' (2010) European Taxation, issue 10, 445.

The exclusion of Article 4(1)(b) is mainly relevant for profit-participating loans, i.e., loans with an interest rate that is linked to the borrower's profitability. It is clear that such loans are liable to be subject to Article 4(1)(b). However, since the provision refers to any debt-claim with 'a right to participate in the debtor's profits', it is sufficiently broad to also cover, for instance, loans that provide for a fixed interest component and additional variable remuneration on the basis of the borrower's profitability. It should be noted, however, that Article 4(1)(b) expressly requires that it concerns a right to participate in the *debtor's* profits. The provision therefore does not allow the source state to disallow the benefits of the Directive where it concerns a debt-claim carrying a right to participate in another entity's profits (such as a subsidiary of the borrower). **16.022**

It has been argued that Article 4(1)(b) of the Directive gives a source state the possibility to exclude jouissance rights and silent partnerships from the scope of application of both the Interest and Royalties Directive and the Parent-Subsidiary Directive by classifying them as debt under domestic law (as a result of which they are excluded from the scope of the Parent-Subsidiary Directive) and using the option of Article 4(1)(b) to exclude them from the scope of the Interest and Royalties Directive.[11] **16.023**

4. Convertible debt-claims

Article 4(1)(c) contains an optional exclusion for 'payments from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits'. This exclusion appears to refer to convertible loans, but it is remarkable that the provision does not refer to a right to convert the loan to equity, instead referring to a right for 'the creditor to exchange his right to interest for a right to participate in the debtor's profits'. **16.024**

It is clear that that wording covers interest-bearing loans that allow the creditor to convert his entitlement to interest into the right to a percentage of the profits of the borrower. It has been argued, however, that Article 4(1)(c) does not necessarily apply to (all) financial instruments that grant the right to convert the loan into share capital. The reason is that the provision does not expressly refer to a conversion into equity, and it only refers to the entitlement for the creditor to exchange 'his right to interest' without mentioning the principal on **16.025**

11 E. Eberhartinger and M. Six, 'National Tax Policy, the Directives and Hybrid Finance' in K. Andersson, E. Eberhartinger and L. Oxelheim (eds.), *National Tax Policy in Europe* (Springer 2007), 228.

which the interest is paid or accrued.[12] It could be argued, however, that such a literal interpretation is difficult to square with the Directive's objectives.

16.026 Another criticism that has been levelled at the text of Article 4(1)(c) is that it suggests that the optional exclusion applies to payments on convertible loans from the start, even before the right to conversion has been exercised (and even if the creditor never decides to exercise that right). It is unlikely that this is the intended meaning of the provision.[13] That interpretation would also be difficult to square with the assumption that the Directive should, insofar as possible, be interpreted in line with the OECD position on related tax treaty issues. Indeed, the OECD Commentary takes the position that 'interest on participating bonds should not normally be considered as a dividend, and neither should interest on convertible bonds until such time as the bonds are actually converted into shares' (unless the lender effectively shares the risks run by the company).[14]

16.027 Similarly to Article 4(1)(b) of the Directive, the exclusion only concerns instruments that allow the creditor to participate in the *debtor's* profits (after the conversion). Article 4(1)(c) therefore does not apply to exchangeable debt, i.e. debt securities that can be converted into the shares of a company other than the debtor (e.g., a subsidiary of the debtor). Furthermore, Article 4(1)(c) only applies to instruments that grant conversion rights to the *creditor*. Given its wording, the provision does not apply to instruments that only allow the issuer to opt for conversion (e.g., reverse convertible bonds). Finally, Article 4(1)(c) does not appear to apply to instruments that are necessarily and automatically converted into equity (e.g. 'Obligations Remboursables en Actions' in France) since, in such cases, there is no entitlement for the creditor to decide whether to convert.

5. Perpetual loans

16.028 The final optional exclusion concerns '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'. The Directive thus appears to consider that instruments that do not provide for the repayment of the principal amount or that provide for a very long repayment term (e.g.,

12 M. Distaso and R. Russo, 'The EC Interest and Royalties Directive – A Comment' (2004) European Taxation, issue 4, 150.

13 D. Weber, 'The proposed EC Interest and Royalty Directive' (2000) EC Tax Review, issue 1, 26.

14 Com. OECD (2017) on article 11, para. 19.

perpetuals) are more equity-like in nature, and may therefore be excluded from the benefits of the Directive.[15]

The *Viva Telecom Bulgaria* case, which has already been referred to above, concerned an interest-free loan agreement of 60 years. According to the Advocate-General, the exclusion in Article 4(1)(d) of the Directive applied to that situation: **16.029**

> even if notional interest could be regarded as 'interest payments' for the purpose of Directive 2003/49, those payments, since they relate to an interest-free loan scheduled to mature 60 years after its conclusion, fall within the derogation provided for in Article 4(1)(d) of that directive, which excludes from its scope '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'. The term of the loan at issue was 60 years, meaning that Directive 2003/49 does not apply to the present case.[16]

In its decision, the Court of Justice did not address the interpretation of Article 4(1)(d). The reason is that the Court's analysis was restricted to considering that notional interest cannot be regarded as an interest payment for either Article 1, 2 or 4 of the Directive, as a result of which the Directive did not apply.[17] **16.030**

C. ARTICLE 4(2): COMPULSORY EXCLUSION

1. Background

Article 4(2) of the Directive provides for a compulsory exclusion of non-arm's length payments between associated parties. In particular, the Directive does not apply to the portion of a payment that exceeds the arm's length amount if the deviation from the arm's length standard is due to a special relationship. This provision was included to prevent that the benefits of the Directive are available in situations involving profit-shifting schemes. Because interest and royalty payments are generally deductible at the level of the payor, they can be used to transfer profits from a high-taxed entity to a low-taxed entity. Such **16.031**

15 See also Com. OECD (2017) on article 10, para. 25: 'Article 10 deals not only with dividends as such but also with interest on loans insofar as the lender effectively shares the risks run by the company, i.e. when repayment depends largely on the success or otherwise of the enterprise's business. [. . .] The question whether the contributor of the loan shares the risks run by the enterprise must be determined in each individual case in the light of all the circumstances, as for example the following: [. . .] the loan contract contains no fixed provisions for repayment by a definite date'.

16 Opinion of Advocate General Rantos, Case C-257/20 Viva Telecom Bulgaria [2022] ECLI:EU:C:2021:779, para. 59.

17 Case C-257/20 Viva Telecom Bulgaria [2022] ECLI:EU:C:2022:125, para. 55-56.

practices may particularly occur within multinational groups of companies (for instance, a parent company that is subject to a high tax rate making exorbitant interest payments to a subsidiary that is established in a low-tax jurisdiction). Article 4(2) of the Directive seeks to prevent that the benefits of the Directive would be claimed in such a scenario.

16.032 Article 4(2) of the Directive uses the arm's length standard as a benchmark, i.e., the amount of interest or royalties that would have been agreed by independent parties. The exclusion therefore does not cover domestic measures that are solely based on fixed thresholds (such as a fixed debt/equity ratio in the context of interest payments, or a fixed maximum percentage of the value of an intangible asset that can be paid as a royalty) rather than considering the amount that independent parties would have agreed in similar circumstances.[18]

16.033 The OECD Model Convention includes a similar mechanism for interest in Article 11(6) and for royalties in Article 12(4). The first of those provisions reads as follows:

> Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

16.034 Article 12(4) of the OECD Model reads as follows:

> Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention

16.035 This mechanism of these provisions is quite similar to that of Article 4(2) of the Directive: the provision also applies if the amount of an interest payment (or, in the case of Article 12(4), a royalty payment) is not at arm's length as

18 Note for completeness' sake that adherence to the arm's length standard may also be taken into account to determine whether domestic thin capitalisation rules are proportionate to the objective of preventing tax avoidance (e.g., Case C-524/04, Test Claimants in the Thin Cap Group Litigation [2007] ECLI:EU:C:2007:161, para. 80).

a result of a special relationship. Its effect is that Articles 11 or 12 no longer apply to the excessive part of the payment. This means, most notably, that the source state is not required to restrict its withholding tax on interest to the rate agreed in Article 11(2) nor to grant an exemption for royalties under Article 12(1). The explanatory memorandum to the Directive expressly states that Article 4(2) of the Directive is 'in line with the principles of Articles 11.6 and 12.4 of the OECD Model Tax Convention on income and on capital'.[19]

A remarkable difference between Article 4(2) of the Directive and the two provisions in the OECD Model is that the latter expressly consider 'the debt-claim for which [the interest] is paid' and 'the use, right or information for which [the royalties] are paid'. No such wording is included in Article 4(2) of the Directive. It has been argued that this difference can be explained by the different purposes of the two provisions in the OECD Model and Article 4(2) of the Directive. In particular, the argument is that Articles 11(6) and 12(4) of the OECD Model are mere transfer pricing provisions that only allow for an adjustment of the interest rate or the royalty amount and not for the reclassification of the loan or royalty agreement in such a way as to give it a different character (e.g., a contribution to equity capital).[20] According to this argument, Article 4(2) of the Directive is worded differently because it functions not only as a transfer pricing provision (that allows for an adjustment of the interest rate or the royalty amount) but also as a thin capitalisation rule that allows for a loan or royalty agreement to be reclassified as, for instance, a contribution to equity capital.[21] **16.036**

19 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, Explanatory memorandum, COM(1998) 67 final, 98/0087, 8.

20 Com. OECD (2017) on article 11, para. 35: 'This paragraph permits only the adjustment of the rate at which interest is charged and not the reclassification of the loan in such a way as to give it the character of a contribution to equity capital. For such an adjustment to be possible under paragraph 6 of Article 11, it would be necessary as a minimum to remove the limiting phrase "having regard to the debt-claim for which it is paid"'. Com. OECD (2017) on article 12, para. 22: 'The paragraph permits only the adjustment of the amount of royalties and not the reclassification of the royalties in such a way as to give it a different character, e.g. a contribution to equity capital. For such an adjustment to be possible under paragraph 4 of Article 12, it would be necessary as a minimum to remove the limiting phrase "having regard to the use, right or information for which they are paid"'.

21 S. Fernandes e.a., 'A Comprehensive Analysis of Proposals to Amend the Interest and Royalties Directive – Part 2' (2011) European Taxation, 455.

16.037 As noted, the 1998 Commission proposal contained a provision that is similar to the current Article 4(2) as a separate Article 5.[22] The wording of that provision, however, was slightly different from the current version:

> Where, by reason of the special relationship between the payer and the beneficial owner of interest or royalties, or between both of them and some other person, the amount of that income or those payments exceeds the amount which would have been agreed by the payer and the beneficial owner in the absence of such a relationship, the provisions of this Directive shall apply only to the latter amount; and, in the case of interest, where by reason of such a relationship the amount of the debt-claim in respect of which the interest is paid exceeds the amount which would have been agreed by the payer and the beneficial owner in the absence of such a relationship, the provisions of this Directive shall apply only to interest of the latter amount, if any.

16.038 Two differences stand out. First, Article 5 of the 1998 proposal does not refer to a 'special relationship between the payer and the beneficial owner of interest or royalties, or between *one of them* and some other person' but to a 'special relationship between the payer and the beneficial owner of interest or royalties, or between *both of them* and some other person' (emphasis added).

16.039 Secondly, Article 4(2) of the Directive applies if the amount of interest or royalties exceeds the amount that would have been agreed in the absence of the special relationship. Article 5 of the 1998 proposal added that it also applied if the amount of the debt-claim in respect of which interest is paid was excessive. Despite that difference, however, the Commission appears to consider that Article 4(2) of the Directive is still intended to function as a thin capitalisation provision that would also apply if the amount of the debt-claim is not at arm's length.[23] This question is of particular relevance for domestic thin capitalisation rules that do not recharacterise interest on excessive debt-claims as a dividend (since domestic thin capitalisation rules that do would already be covered by Article 4(1)(a) of the Directive; see section 2.2 above). It has been argued that the wording of Article 4(2) is sufficiently broad to allow for the interpretation proposed by the Commission.[24]

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22 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 of 4 March 1998, O.J. 1998 C 123/9.

23 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, 17 April 2009, COM(2009) 179 final, 7.

24 S. Douma et al. (eds.), *Terra/Wattel European Tax Law* (Vol. I, Kluwer Law International 2022), para. 18.2.4.2, p. 627. A different position appears to be taken in M. Gusmeroli, 'Triangular Cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 2' (2005) European Taxation, 44.

2. Special relationship

The Directive does not define the concept 'special relationship' as it is used in Article 4(2) of the Directive, nor does it list criteria that may be used for assessing the existence of such a relationship. Given the wording and objective, however, it appears that the concept is intended to be broader than the concept 'associated company' as it is used in Article 3(b) of the Directive (on the latter concept, reference is made to Chapter 15). **16.040**

Given the similarity to the wording and purpose of Article 11(6) and 12(4) of the OECD Model, inspiration could be drawn from the OECD guidance to interpret that concept. Those provisions in the OECD Model also use the expression 'special relationship', and the OECD Commentary clarifies that that expression is broader than the concept 'associated enterprises' as it is used in the context of Article 9 of the OECD Model. The OECD Commentary states that examples of a special relationship include cases 'where interest is paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him' (i.e., the situations covered by Article 9 of the OECD Model) but that it also includes 'relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the interest'.[25] **16.041**

That being said, the absence of guidance in the Directive on the interpretation of the expression 'special relationship' may result in divergent interpretations of the Directive's scope of application.[26] For that reason, legal literature has criticised the Directive for potentially causing legal uncertainty.[27] **16.042**

3. Effects

If the conditions for Article 4(2) are met, the result is that the Directive does not apply to the excessive portion of the interest or royalty payment, i.e., the part of the payment that is not in accordance with the arm's length principle. The main consequence is that that portion of the payment is not entitled to an exemption in the source state. As noted, this is an obligation rather **16.043**

25 Com. OECD (2017) on article 11, para. 33-34; Com. OECD (2017) on article 12, para. 23-24.

26 For instance, J. Schwarz, 'European Corporate Group Structures and Financing: The Impact of European Court Decisions and European Legislative Developments' (2003) Bulletin for International Taxation, 516, who points out that in United Kingdom practice, 'special relationship' is generally thought to mean control.

27 L. Cerioni, 'Intra-EC Interest and Royalties Tax Treatment' (2004) European Taxation, 52.

than an option for the source state (unlike the exclusions in Article 4(1); see section 2 above).

16.044 Article 4(2) does not impose any obligation on the beneficial owner's home state. That state is therefore not required to eliminate the double taxation that may occur when the source state applies a withholding tax to the excessive portion of the payment.

16.045 On the question whether payments that are excluded from the benefits of the Directive on the basis of article 4(2) are entitled to the benefits of the Parent-Subsidiary Directive, reference is made to Chapter 2.

D. RELATIONSHIP BETWEEN ARTICLE 4(1) AND ARTICLE 4(2)

16.046 A final question to be addressed concerns the relationship between the optional exclusions of Article 4(1) and the compulsory exclusion of Article 4(2). This question is of particular relevance for domestic rules that concern one of the situations listed in Article 4(1), such as domestic thin capitalisation rules that classify debt as interest if certain limits are exceeded. It is not immediately clear whether Article 4(2) is also relevant for such rules.[28] Assume, for instance, that a domestic thin capitalisation rule reclassifies interest payments as dividends insofar as a fixed debt/equity ratio is exceeded. It is clear that such a measure is covered by the optional exclusion of Article 4(1)(a), but it is less clear whether that domestic rule should also comply with the arm's length principle enshrined in Article 4(2).

16.047 In this context, it is interesting to note that a European Parliament report on the 1998 proposal recommended deleting the provision with optional exclusions (i.e., Article 4 in the 1998 proposal) because its relationship to the compulsory exclusion (Article 5 in the 1998 proposal) was unclear.[29] Whatever the proper interpretation may be, it is clear that such domestic rules must in any event comply with the requirements of the Treaty freedoms, as clarified in the Court of Justice's case law.[30]

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28 See also D. Weber, 'The proposed EC Interest and Royalty Directive' (2000) EC Tax Review, issue 1, 26.

29 Report on the 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(98)0067 - C4-0195/98 - 98/0087(CNS), A4-0299/1998: "It is by no means easy to establish the relationship between Art. 4 and Art. 5. [. . .] It seems that practical cases could regularly be subsumed under both articles. The necessity for Art. 4 seems doubtful. Deleting Art. 4 or introducing an unequivocal distinction between the scope and legal effect of Art. 4 and 5 should seriously be considered."

30 E.g. Case C-324/00 Lankhorst-Hohorst GmbH [2002] ECLI:EU:C:2002:749.

Obviously, the issue is fairly straightforward if the matter is *not* governed by Article 4(1). Consider, for instance, a domestic thin capitalisation rule that does not classify interest as a dividend but simply disallows the deductibility of interest if a fixed debt/equity ratio is exceeded. In such a case, it is clear that Article 4(1)(a) of the Directive is not applicable. That domestic rule would be incompatible with the Directive insofar as it goes beyond the arm's length standard in Article 4(2) of the Directive (i.e., insofar as it disallows the deduction of an arm's length amount of interest). Indeed, Article 1(1) of the Directive prohibits 'any taxes' from being imposed in the source state, including the tax that results from the interest deduction being disallowed (see Chapter 13). **16.048**

17

ARTICLE 5: ABUSE

Jean -Philippe Van West

1. **This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse.**
2. **Member States may, in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse, withdraw the benefits of this Directive or refuse to apply this Directive.**

COMMENTARY

A. BACKGROUND

17.001 Since the adoption of the EU Interest and Royalty Directive[1] (hereinafter IRD) in June 2003, the wording of Article 5 IRD has remained unchanged. As is clear from the text quoted above, Article 5 IRD, which is labelled “Fraud and Abuse”, contains two anti-abuse provisions.[2]

1 Council Directive 2003/49/EC of 3 “June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Companies of Different Member States [2003] OJ L157/49”.

2 Note that the IRD contains several "specific anti-abuse provisions”, e.g. in Article 1(4), Article 1(10) and Art 4.

The wording of Article 5(1) IRD is identical to the original wording of Article 1(2) PSD (now Article 1(4) PSD), and the author expects that it will be interpreted by the CJEU in the same way.[3] Hence, reference is made to the chapter on the discussion of abuse under the PSD (Chapter 3) for a discussion, in particular Section D.2.b and Section E. In summary, from the case law of the CJEU on Article 1(2) PSD (now Article 1(4) PSD), it can be derived that Article 5(1) IRD reflects the general principle of EU law that any abuse of rights is prohibited[4] and needs to be interpreted strictly because it is regarded as an exception to the general rules.[5] Furthermore, the CJEU has set clear boundaries to the possibility for Member States to introduce domestic anti-abuse rules based on Article 1(4) PSD (old Article 1(2) PSD), and according to the author, this case law is also relevant for the interpretation of Article 5(1) IRD. Hence, domestic anti-abuse rules based on Article 5(1) IRD addressing abuse of the IRD must be proportional, taking into account the object and purpose of the PSD and must respect the fundamental freedoms. They must be designed to address purely artificial arrangements, cannot create general, irrebuttable presumptions of fraud and abuse, and the taxpayer who is denied the benefits of the PSD must be granted the possibility to provide evidence demonstrating the existence of economic reasons. Given the decision of the CJEU in the Danish cases that Member States have an obligation to address abuse of the IRD,[6] Article 5(1) IRD becomes redundant in the sense that the reservation contained in said Article for Member States not to implement measures preventing abuse turns out to be meaningless. **17.002**

The wording of Article 5(2) IRD resembles Article 15 (1) (a) of the Merger Directive (old Article 11 (1) (a) of the Merger Directive). In the Kofoed Case, the CJEU held that Article 11(1)(a) of the Merger Directive reflects the general Community law principle that abuse of rights is prohibited.[7] Furthermore, on several occasions, the CJEU ruled that it is only by way of exception and in specific cases that Member States may, pursuant to Article 11(1)(a) of the **17.003**

3 See e.g. also A. Cordewener, 'The Interest and Royalties Directive' in B. Terra et al. (eds), *European Tax Law - Student edition*, (Wolters Kluwer 2022), 18.7.1.

4 Case C-6/16 Eqiom and Enka [2017] ECLI:EU:C:2017:641, para 26.

5 Case C-6/16 Eqiom and Enka [2017] ECLI:EU:C:2017:641and Joined Cases C-504/16 and C-613/16 Deister Holding AG and Juhler Holding A/S v Bundeszentralamt für Steuern [2017] ECLI:EU:C:2017:1009.

6 Joined Cases C-116/16 and C-117/16 T Danmark and Y Denmark Aps v Skatteministeriet [2019] ECLI:EU:C:2019:135, para. 83 (hereafter the 'Danish PSD Cases') and Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16 N Luxembourg 1 and Others v Skatteministeriet [2019] ECLI:EU:C:2019:134, para. 101 (hereafter the 'Danish IRD Cases').

7 Case C-331/05 Kofoed [2007] ECLI:EU:C:2007:408, para 38.

Merger Directive, refuse to apply or withdraw the benefit of all or any part of the provisions of that directive.[8] As a provision setting out an exception, Article 11(1)(a) of the Merger Directive must be subject to strict interpretation, regard being had to its wording, purpose and context.[9] Given the similar wording, it is argued that the aforementioned decisions of the CJEU regarding the interpretation of Article 15 (1) (a) of the Merger Directive (old Article 11(1)(a) of the Merger Directive) also apply to Article 5(2) IRD. However, more important than the decisions of the CJEU on the application of the GAAR in the Merger Directive for the interpretation of Article 5(2) IRD is the decision of the CJEU in the Danish IRD Cases. In this decision, the CJEU ruled on abuse of the IRD and provided indicators of abuse of the IRD. The remainder of this contribution provides a summary of the decision of the CJEU in the Danish IRD Cases and the elements that can be derived from this case for the interpretation of Article 5(2) of the IRD.[10]

B. ABUSE OF THE IRD IN THE CASE LAW OF THE CJEU – THE DANISH IRD CASES

1. General

17.004 The Danish IRD Cases concerned four joined Cases[11] dealing with interest payments by a Danish company to a group entity resident in another Member

8 Case C-331/05 Kofoed [2007] ECLI:EU:C:2007:408, para 37; Case C-285/07 A.T. v Finanzamt Stuttgart-Körperschaften [2008] ECLI:EU:C:2008:568, para 31; Case C-352/08 Zwijnenburg v Inspecteur van de Belastingdienst [2009] ECLI:EU:C:2009:749, para 45; Case C-14/16 Euro Park Services v Ministère des Finances et des Comptes publics [2017] ECLI:EU:C:2017:177, para 48.

9 Case C-352/08 Zwijnenburg v Inspecteur van de Belastingdienst [2009] ECLI:EU:C:2009:749, para 46; Case C-14/16 Euro Park Services v Ministère des Finances et des Comptes publics [2017] ECLI:EU:C:2017:177, para 49.

10 Note that this chapter deliberately does not follow the same structure as the commentary on the PSD GAAR. The PSD GAAR formed an amendment to the PSD and, as illustrated in Section C of the discussion of the PSD GAAR (Chapter 3), significant differences exist between the wording of the PSD GAAR and the 2-prong abuse test as development in the case law of the CJEU. Hence, a more detailed analysis of the PSD GAAR and its interaction with the general principle of prohibition of abuse of EU law is justified. Regarding Article 5 IRD, however, the situation is different because (i) Article 5 IRD remained unchanged since the adoption of the IRD, (ii) the CJEU ruled regarding Article 15(1)(a) of the Merger Directive (old Article 11 (1) (a) of the Merger Directive which resembles Article 5(2) IRD) that this provision reflects the general Community law principle that abuse of rights is prohibited, and (iii) when the CJEU rendered its decision in the Danish IRD Cases, the wording of the IRD was the same as it is today. Hence, regarding Article 5(2), according to the author, fewer interpretative questions arise on how to reconcile the wording of the IRD with the 2-prong abuse test as development in the case law of the CJEU, as opposed to aligning the wording of the PSD GAAR with said two-prong test, which justifies a different approach.

11 Danish IRD Cases.

State (either in Luxembourg or in Sweden) whereby an exemption from WHT was claimed provided under the IRD, but whereby the Danish tax authorities refused to grant the exemption.[12] The different fact patterns are complex but can be summarised as follows.

In the case N Luxembourg 1 (Case C-115/16), five private equity funds established in third countries set up companies in Luxembourg to acquire a holding in a Danish company.[13] The case X Denmark (Case C-118/16) involved interest payments by a Danish company to a Swedish group entity, which was held by a société d'investissement en capital à risque (SICAR) established in Luxembourg and operated as a limited partnership with share capital. The SICAR was in turn held by private equity funds.[14] The case C Danmark I (Case C-119/16) involved a chain of companies whereby, after a restructuring an entity established in the US held, via a chain of intermediate entities established in the Cayman Islands, Sweden, and Denmark a participation in a Danish entity which was the ultimate parent company of a group of entities.[15] In the case Z Denmark (Case C-299/16), a private equity fund consisting of five funds acquired a majority participation in a Danish industrial undertaking. Four of the funds were set up in the form of limited partnerships in Jersey and were treated as tax transparent for Danish tax purposes; however, the fifth fund was treated as a non-transparent entity.[16] **17.005**

The four cases (Danish IRD Cases) have in common that the respective group entities that granted the loans to the respective Danish companies had themselves obtained loans from other group entities for similar amounts and interest rates (back-to-back financing transactions). As a consequence, the interest income they received was offset against the interest payment obligations they had, resulting in a low taxable profit. The Danish tax authorities refused to grant an exemption from WHT provided for under Article 1 IRD for the interest payments by the respective Danish companies to the respective group **17.006**

12 The Danish IRD Cases have been intensively discussed in literature. See for example A. Zalasiński, 'The ECJ's Decisions in the Danish 'Beneficial Ownership' Cases: Impact on the Reaction to Tax Avoidance in the European Union' (2019) International Tax Studies, issue 4; S. Baerentzen, 'Danish Cases on the Use of Holding Companies for Cross-Border Dividends and Interest – A New Test to Disentangle Abuse from Real Economic Activity?' (2020) World Tax Journal, issue 1, 3; J. Englisch, 'The Danish Tax Avoidance Cases: New Milestones in the Court's Anti-Abuse Doctrine' (2020) Common Market Law Review, issue 2, 503–37; L. De Broe et al., 'Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases' (2019) EC Tax Review, issue 6, 270–99.

13 Danish IRD Cases, paras 30-45.

14 Danish IRD Cases, paras 46-57.

15 Danish IRD Cases, paras 58-63.

16 Danish IRD Cases, paras 64-79.

entity resident in the other Member States. They were of the opinion that the group entities receiving the interest payments from the respective Danish companies were not the beneficial owners of the income and that the structures were set up to avoid WHT on interest payments to third countries (i.e. cases of directive shopping).

17.007 A key aspect of the Danish IRD Cases was that Denmark did not have a written general anti-abuse rule in place to deny the benefits of the IRD, and the first issue addressed by the CJEU was whether this prevented Denmark from denying the exemption of WHT. The CJEU ruled that a general legal principle exists in EU law which states that EU law cannot be relied on for abusive or fraudulent ends[17] and that it follows from that principle "that a Member State must refuse to grant the benefit of the provisions of EU law where they are relied upon not with a view to achieving the objectives of those provisions but with the aim of benefiting from an advantage in EU law although the conditions for benefiting from that advantage are fulfilled only formally".[18] In a later paragraph, the CJEU *added that* "in the light of the general principle of EU law that abusive practices are prohibited and of the need to ensure observance of that principle when EU law is implemented, the absence of domestic or agreement-based anti-abuse provisions does not affect the national authorities' obligation to refuse to grant entitlement to rights provided for by Directive 2003/49 where they are invoked for fraudulent or abusive ends".[19] The decision of the CJEU in the Danish IRD Cases entails that Member States have an obligation to address abuse of the IRD, which makes Article 5(1) and 5(2) of the IRD redundant in the sense that the reservation contained in these provisions not to implement measures preventing abuse becomes, turns out to be meaningless.[20]

2. The relationship between the general principle of prohibition of abuse of EU law and Article 5 IRD

17.008 In Section 4 of the discussion on the PSD GAAR (Chapter 3), the relation is between the general principle of prohibition of abuse of EU law, as developed

17 Danish IRD Cases, para 96.
18 Danish IRD Cases, para 98.
19 Danish IRD Cases, para 101.
20 L. De Broe et al., 'Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases' (2019) EC Tax Review, issue 6, 276–280. This position of the CJEU is subject to criticism. See e.g. W. Schön, 'The Concept of Abuse of Law in European Taxation: A Methodological and Constitutional Perspective' (20 November 2019), Working Paper of the Max Planck Institute for Tax Law and Public Finance No. 2019-18, Available at SSRN: https://ssrn.com/abstract=3490489.

in the case law of the CJEU, and the PSD GAAR. The author takes the position that, based on the case law of the CJEU, it can convincingly be argued that there is only one overarching anti-abuse principle of which the exact scope depends on among others, the facts of the case and the object and purpose of the law that is allegedly abused.[21] The general principle of prohibition of abuse of EU law and Article 5 IRD are two different instruments, for which the interpretation in cases of alleged abuse of the IRD has to be reconciled. If one reads Article 5(2), it is true that said provision does not contain an explicit reference to the object or aim of the IRD. Hence, it could be argued that abuse can exist even in the absence of the fulfilment of the objective test. Such a position does, however, not find support in the case law of the CJEU. Article 5(2) IRD has to be interpreted and applied in light of the general principle of prohibition of abuse of EU law, and in the Danish IRD Cases, the CJEU made clear that abuse of the IRD requires a combination of objective circumstances in which, despite formal observance of the conditions laid down by the EU rules, the purpose of those rules has not been achieved and, second, a subjective element consisting of the intention to obtain an advantage from the EU rules by artificially creating the conditions laid down for obtaining it.[22] The wording of Article 5(2) IRD leaves sufficient leeway for the court to interpret said provision in line with its existing case law on the general principle of prohibition of abuse of EU law.

3. Subjective test

According to Article 5(2) IRD, Member States may deny the benefits of the IRD if the principal motive or one of the principal motives of a transaction is tax evasion, tax avoidance or abuse. This wording seems to suggest that the motive(s) of a transaction must be identified, with a distinction to be made between principal motive(s) and other motive(s). In the past, there was debate about how this subjective test should be interpreted. In particular because in case law on Article 15(1)(a) of the Merger Directive (old Article 11 (1) (a) of the Merger Directive which resembles Article 5(2) IRD), the CJEU used the **17.009**

21 L. De Broe, 'Tax Abuse in the European Union: The Current State of Affairs' (2022) *World Tax Journal*, issue 3, 5-9; R. de la Feria, 'EU General Anti-(Tax) Avoidance Mechanisms: From GAAP to GAAR' (1 November 2019), SSRN Scholarly Paper, 1-2, https://doi.org/10.2139/ssrn.3485784.

22 Danish IRD Cases, para 124.

terms "solely",[23] "sole"[24] or "predominant".[25] In the Danish IRD Cases, however, which is the leading decision of the CJEU regarding abuse of the IRD, the CJEU explicitly referred to the essential aim in addition to the sole aim.[26]

17.010 In this regard, it could be argued that if a certain arrangement does not lead to a tax advantage, such arrangement should generally not lead to abuse of the IRD because it is hard to see how it would be put into place for the essential or sole aim of obtaining a tax advantage.[27] One can think of the situation whereby a company resident in an EU Member State makes an interest payment to a company resident in a third country and under an applicable double tax treaty between the third country and the EU Member State, the WHT is reduced to 0%. In such a situation, it could be argued that interposing an intermediate holding company in another EU Member State should generally not be regarded as abuse of the IRD because it is hard to defend that the structure was put into place for the essential or sole aim of obtaining a tax advantage. In its decision in the Danish cases, however, the CJEU found, among others that it is immaterial that some of the beneficial owners of the interest paid by the conduit company are resident for tax purposes in a third State which has concluded a double taxation convention with the source Member State and that the existence of such a convention cannot in itself rule out an abuse of rights.[28]

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23 Case C-331/05 Kofoed [2007] ECLI:EU:C:2007:408, para 38: "The application of Community legislation cannot be extended to cover abusive practices, that is to say, transactions carried out not in the context of normal commercial operations, but <u>solely</u> for the purpose of wrongfully obtaining advantages provided for by Community law" (emphasis added).

24 Case C-14/16 Euro Park Services v Ministère des Finances et des Comptes publics [2017] ECLI:EU:C:2017:177, para 52: "concerning the presumption of tax evasion or tax avoidance under Article 11(1)(a) of Directive 90/434, it should be recalled that that provision authorizes Member States to provide for a presumption of tax evasion or tax avoidance only where the planned operation has the <u>sole</u> objective of obtaining a tax advantage and is thus not carried out for valid commercial reason".

25 Case C-126/10 Foggia – Sociedade Gestora de Participações Sociais SA v Secretário de Estado dos Assuntos Fiscais [2011] ECLI:EU:C:2011:718: "Consequently, a merger operation based on several objectives, which may also include tax considerations, can constitute a valid commercial reason provided, however, that those considerations are not <u>predominant</u> in the context of the proposed transaction" (emphasis added).

26 Danish IRD Cases, para 107: "To permit the setting up of financial arrangements whose <u>sole aim</u> is to benefit from the tax advantages resulting from the application of Directive 2003/49 would not be consistent with such objectives and, on the contrary, would undermine economic cohesion and the effective functioning of the internal market by distorting the conditions of competition. As the Advocate General has, in essence, observed in point 63 of her Opinion in Case C-115/16, that would also be the case even if the transactions at issue do not exclusively pursue such an aim, as the Court has held that the principle that abusive practices are prohibited applies, in tax matters, where the accrual of a tax advantage constitutes the <u>essential aim</u> of the transactions at issue" (emphasis added).

27 The same remark was made when discussing the PSD GAAR. See Section C.2.b of the discussion of the PSD GAAR (Chapter 3) and the references there.

28 Danish IRD Cases, para. 135. For criticism of that position of the CJEU see e.g. L. De Broe et al., 'Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases' (2019) EC

4. Objective test

Article 5(2) IRD does not explicitly refer to the objectives of the Directive. However, because Article 5(2) IRD resembles Article 15 (1) (a) of the Merger Directive (old Article 11 (1) (a) of the Merger Directive), which according to the CJEU reflects the general Community law principle that abuse of rights is prohibited, and because of the decision of the CJEU in the Danish IRD Cases, it can be defended that the benefits of the IRD can only be denied based on Article 5(2) IRD if the two elements of the two-prong abuse test are met. **17.011**

The objective test is fulfilled if a tax advantage is obtained that defeats the object or purpose of the IRD. The aim of the IRD can be found in the preamble, in particular in the second, third, and fourth recitals from which it can be derived that the directive has the aim of eliminating double taxation of interest and royalty payments between associated companies of different Member States to spare them burdensome administrative formalities and cash-flow problems and to ensure equality of tax treatment as between national and cross-border transactions.[29] Furthermore it is necessary to ensure that interest and royalty payments are subject to tax once in a Member State.[30] In the Danish IRD BO cases, the CJEU stated that it is apparent from recitals 2 to 4 of Directive 2003/49 that the aim of the directive is that double taxation should be eliminated with respect to interest and royalty payments between associated companies of different Member States and that such payments should be subject to tax once in a single Member State.[31] **17.012**

5. Indicators of abuse

The CJEU provided indicators of abuse, which can result in the denial of the WHT exemption of the IRD. The decision of the CJEU is, in this regard, very similar to its decision in the Danish PSD cases. The CJEU first explained that an examination of the facts is needed to establish whether the constituent elements of an abusive practice are present (i.e. the objective and subjective elements) and whether the contested transactions are purely formal or artificial, devoid of any economic and commercial justification, and with the essential aim of benefiting from an improper advantage.[32] The CJEU further clarified that a group of companies may be regarded as an artificial arrangement if it is **17.013**

Tax Review, issue 6, 284-285.

29 See also Danish IRD Cases, para. 106.

30 Directive 2003/49, recital 3.

31 Danish IRD Cases, para. 85.

32 Danish IRD Cases, para 125.

not set up for reasons that reflect economic reality, its structure is purely one of form, and its principal objective, or one of its principal objectives, is to obtain a tax advantage running counter to the aim or purpose of the applicable tax law.[33] Next, the CJEU provided five situations that can give an indication of the existence of an abusive arrangement[34]:

(1) (almost) all the interest are, very soon after their receipt, passed on by the company that has received them to entities which do not fulfil the conditions for the application of the IRD[35];
(2) The group is structured in such a way that the company which receives the interest must itself pass those interests on to a third company which does not fulfil the conditions for the application of the PSD, and consequently the interposed company makes only an insignificant taxable profit.[36]
(3) It follows from an analysis of all the relevant factors, such as the management of the company, its balance sheet, its cost structure, the expenditure actually incurred, the staff that it employs and the premises and equipment that the interposed company lacks any actual economic activity and that it has as its sole activity the receipt of dividends and their transmission to the beneficial owner or to other conduit companies.[37]
(4) It follows from the various contracts existing between the companies involved in the financial transactions at issue, by the way in which the transactions are financed, by the valuation of the intermediary companies' equity and by the inability to have economic use of the dividends received that the transaction concerns an artificial arrangement. In this regard, one should not only take into account any legal obligation of the parent company receiving the dividends to pass them on to a third party, but also the fact that, "in substance" that a company, without being bound by such a contractual or legal obligation, does not have the right to use and enjoy those dividends.[38]
(5) The aforementioned indicators might be reinforced if complex financial transactions are set up and intragroup loans are granted just before or after the entry into force of major new tax legislation.[39]

17.014 Although these indicators certainly have their relevance, they are only indicators which do not lead to legal certainty and still raise many questions (e.g., what is the weight of the different indicators, how many of them need to be met, . . .).

33 Danish IRD cases, para 127.

34 For a discussion of these indicators, see also L. De Broe et al., 'Danish Dynamite: The 26 February 2019 CJEU Judgments in the Danish Beneficial Ownership Cases' (2019) EC Tax Review, issue 6, 282–86.

35 Danish IRD cases, para 128.

36 Danish IRD cases, para 130.

37 Danish IRD cases, para 131.

38 Danish IRD cases, para 132.

39 Danish IRD cases, para 133.

6. Burden of proof

In its judgement, the CJEU also provided guidance on the burden of proof related to the IRD. It is the responsibility of taxpayers who claim the benefits of the PSD to demonstrate that they meet the formal conditions laid down in the PSD.[40] However, it is up to the tax authorities which seeks to deny the benefits of the PSD to establish the existence of the elements constituting an abusive practice, thereby taking into account all relevant factors.[41] **17.015**

40 Danish IRD cases, paras 140-141.
41 Danish IRD cases, paras 142-145.

18

ARTICLE 6: TRANSITIONAL RULES FOR THE CZECH REPUBLIC, GREECE, SPAIN, LATVIA, LITHUANIA, POLAND, PORTUGAL, AND SLOVAKIA

Niels Bammens

1. **Greece, Latvia, Poland and Portugal shall be authorised not to apply the provisions of Article 1 until the date of application referred to in Article 17(2) and (3) of Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments. During a transitional period of eight years starting on the aforementioned date, the rate of tax on payments of interest or royalties made to an associated company of another Member State or to a permanent establishment situated in another Member State of an associated company of a Member State must not exceed 10% during the first four years and 5% during the final four years.**

Lithuania shall be authorised not to apply the provisions of Article 1 until the date of application referred to in Article 17(2) and (3) of Directive 2003/48/EC. During a transitional period of six years starting on the aforementioned date, the rate of tax on payments of royalties made to an associated company of another Member State or to a permanent establishment situated in another Member State of an associated company of a Member State must not exceed 10%. During the first four years of the six-year transitional period, the rate of tax on payments of interest made to an associated company of another Member State or to a permanent establishment situated in another Member State must not exceed 10%; and for the following two years, the rate of tax on such payments of interest must not exceed 5%.

Spain and the Czech Republic shall be authorised, for royalty payments only, not to apply the provisions of Article 1 until the date of application referred to in Article 17(2) and (3) of Directive 2003/48/EC. During a transitional period of six years starting on the aforementioned date, the rate of tax on payments of royalties made to an

associated company of another Member State or to a permanent establishment situated in another Member State of an associated company of a Member State must not exceed 10%. Slovakia shall be authorised, for royalty payments only, not to apply the provisions of Article 1 during a transitional period of two years starting on 1 May 2004.

These transitional rules shall, however, remain subject to the continued application of any rate of tax lower than those referred to in the first, second and third subparagraphs provided by bilateral agreements concluded between the Czech Republic, Greece, Spain, Latvia, Lithuania, Poland, Portugal or Slovakia and other Member States. Before the end of any of the transitional periods mentioned in this paragraph the Council may decide unanimously, on a proposal from the Commission, on a possible extension of the said transitional periods.

2. **Where a company of a Member State, or a permanent establishment situated in that Member State of a company of a Member State:**

- **receives interest or royalties from an associated company of Greece, Latvia, Lithuania, Poland or Portugal,**
- **receives royalties from an associated company of the Czech Republic, Spain or Slovakia,**
- **receives interest or royalties from a permanent establishment situated in Greece, Latvia, Lithuania, Poland or Portugal, of an associated company of a Member State,**

or

- **receives royalties from a permanent establishment situated in the Czech Republic, Spain or Slovakia, of an associated company of a Member State,**

the first Member State shall allow an amount equal to the tax paid in the Czech Republic, Greece, Spain, Latvia, Lithuania, Poland, Portugal, or Slovakia in accordance with paragraph 1 on that income as a deduction from the tax on the income of the company or permanent establishment which received that income.

3. **The deduction provided for in paragraph 2 need not exceed the lower of:**

(a) **the tax payable in the Czech Republic, Greece, Spain, Latvia, Lithuania, Poland, Portugal or Slovakia, on such income on the basis of paragraph 1,**

or

(b) **that part of the tax on the income of the company or permanent establishment which received the interest or royalties, as computed before the deduction is given, which is attributable to those payments under the domestic law of the Member State of which it is a company or in which the permanent establishment is situated.**

COMMENTARY

A. INTRODUCTION

18.001 Article 6 contains an exception to the general rules on the implementation deadline of the Directive contained in Article 7. As will be discussed in Chapter 19, the original implementation deadline of the Directive was 1 January 2004. When the Directive was first introduced, however, Article 6(1) granted an exception to that deadline to Greece, Portugal and Spain under a transitional regime. Similar exceptions were later granted to a number of new member states when the EU was enlarged. Those transitional regimes will be discussed in the sections below, followed by a brief analysis of Article 6(2) and (3) of the Directive, which govern the treatment of payments subject to a transitional regime in the member state of the recipient company or permanent establishment.

18.002 Since these transitional regimes have all expired, the discussion below is mainly relevant for historical purposes and will therefore be fairly brief.

B. ARTICLE 6(1): TRANSITIONAL REGIMES

1. Transitional rules applicable to Greece, Portugal and Spain under the 2003 Directive

18.003 According to Article 6(1) of the Directive, Greece, Portugal and Spain were not required to apply the withholding tax exemption provided for in Article 1 of the Directive during a transitional period. In the case of Greece and Portugal, that exception related to both interest and royalty payments, while for Spain it only concerned royalty payments. The seventh recital of the Directive's preamble explains that the transitional regime was applied to Greece and Portugal 'for budgetary reasons', while the eighth recital states that 'Spain, which has launched a plan for boosting the Spanish technological potential, for budgetary reasons should be allowed during a transitional period not to apply the provisions of Article 1 on royalty payments'.

The 1990 Commission proposal only included a transitional regime for Greece and Portugal,[1] not for Spain. The same is true of the 1998 proposal.[2] The explanatory statement on the latter proposal stated that allowing Greece and Portugal to retain a withholding tax during a transitional period was intended to 'alleviate the budgetary impact of the interest and royalties proposal on Greece and Portugal, which are net importers of capital and technology'.[3] 18.004

Under Article 6(1) of the Directive, Greece, Portugal and Spain were permitted to apply their domestic withholding tax rates until 1 July 2005.[4] During an eight-year period starting on that date, the maximum withholding tax rate on qualifying interest and royalty payments in Greece and Portugal was gradually decreased from 10% (in the first four years) to 5% (in the final four years). After that eight-year period, Greece and Portugal were required to grant an exemption under Article 1 of the Directive. For Spain, a six-year period started on 1 July 2005, during which the maximum withholding tax rate on qualifying royalties was 10%. After that period, Spain was required to grant a full exemption under Article 1. Article 6(1) of the Directive states that, before 18.005

1 Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, COM(90) 571 final of 28 November 1990, O.J. 1991 C 53/26, article 5: 'Notwithstanding Article 1, Greece and Portugal may levy a withholding tax on interest and royalty payments made by subsidiaries to parent companies in other Member States until a date not later than the end of the seventh year following the date of application of this Directive. Subject to the existing, bilateral agreements concluded between Greece or Portugal and a Member State, the rate of this withholding tax may not exceed 10% during the first five years and 5% during the last two years of that period. Before the end of the seventh year, the Council shall decide unanimously, on a proposal from the Commission, on a possible extension of the provisions of this Article.'

2 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 of 4 March 1998, O.J. 1998 C 123/9, article 8(1): 'Greece and Portugal shall be authorised not to apply the provisions of Article 1 during a transitional period ending five years after the date of entry into force of this Directive. In such a case the rate of tax on payments of interest or royalties made to an associated company of another Member State or to a permanent establishment situated in another Member State of an associated company of a Member State may not exceed 10% during the first two years and 5% during the final three years. Before the end of the fifth year, the Council may decide, on a proposal from the Commission, to extend the term of the transitional period provided for in this paragraph.'

3 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, Explanatory memorandum, COM(1998) 67 final, 98/0087, 8.

4 Article 6(1) of the Directive established that date by referring to the implementation deadline of the (since repealed) Savings Directive (see article 17(2) and (3) of Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, OJ L 157, 26 June 2003, p. 38-48 and Council Decision 2004/587/EC of 19 July 2004 on the date of application of Directive 2003/48/EC on taxation of savings income in the form of interest payments, OJ L 257, 4 August 2004, p. 7).

the end of any of these transitional periods, the Council (on a proposal from the Commission) could decide to extend them. However, the Council has not made use of that possibility.

2. Transitional rules in the context of the enlargement of the EU

18.006 When it was introduced in 2003, the Directive was addressed to the fifteen countries that were EU member states at that time. As the EU was gradually enlarged, the Directive's territorial scope of application has been expanded to the new member states.[5] A number of those new member states were entitled to similar transitional rules when they acceded to the EU.

18.007 In the context of the 2004 enlargement of the EU, that was the case for the Czech Republic, Latvia, Lithuania, Poland and Slovakia. At the time, it was stated that the application of the Directive was liable to cause budgetary difficulties for those countries 'given the rates of withholding tax applied under national law and on the basis of tax conventions on income and capital and the revenue thus collected.'[6] For that reason, the transitional regime applicable to Greece and Portugal was expanded to Latvia and Poland. Lithuania was also granted the possibility to apply its domestic withholding tax rates to interest and royalty payments until 1 July 2005, but unlike Greece, Latvia, Poland and Portugal, it was subject to a six-year transitional period after that date. During that period, Lithuanian withholding taxes on qualifying royalties were restricted to a maximum rate of 10%, while the maximum rate applicable to qualifying interest payments was 10% during the first four years and 5% during the final two years. Furthermore, the transitional regime that applied to Spain was expanded to the Czech Republic, while Slovakia was granted an

5 See Council Directive 2004/66/EC of 26 April 2004 adapting Directives 1999/45/EC, 2002/83/EC, 2003/37/EC and 2003/59/EC of the European Parliament and of the Council and Council Directives 77/388/EEC, 91/414/EEC, 96/26/EC, 2003/48/EC and 2003/49/EC, in the fields of free movement of goods, freedom to provide services, agriculture, transport policy and taxation, by reason of the accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia, OJ L 168, 1 May 2004, p. 35-67; Council Directive 2006/98/EC of 20 November 2006 adapting certain Directives in the field of taxation, by reason of the accession of Bulgaria and Romania, OJ L 363, 20 December 2006, p. 129–136; and Council Directive 2013/13/EU of 13 May 2013 adapting certain directives in the field of taxation, by reason of the accession of the Republic of Croatia, OJ L 141, 28 May 2013, p. 30-31.

6 Second recital of the preamble to Council Directive 2004/76/EC of 29 April 2004 amending Directive 2003/49/EC as regards the possibility for certain Member States to apply transitional periods for the application of a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 30 April 2004, p. 106-113

exception to Article 1 of the Directive as regards royalties during a transitional period of two years starting on 1 May 2004.[7]

In the context of the 2007 enlargement, transitional rules were also applied to Bulgaria and Romania. In particular, Bulgaria was authorised to apply withholding taxes on qualifying interest and royalties at a maximum rate of 10% until 31 December 2010 and at a maximum rate of 5% for the following years until 31 December 2014, while Romania was authorised to apply withholding taxes on qualifying interest and royalties at a maximum rate of 10% until 31 December 2010.[8] **18.008**

The different transitional regimes described above have all expired. Furthermore, no transitional rules were applied when Croatia became an EU member state in 2013. **18.009**

3. No impact on tax treaty obligations

Obviously, the exception granted by Article 6(1) of the Directive did not affect tax treaty obligations to which the member states in question were subject in the relevant transitional periods. That is to say, the Czech Republic, Greece, Spain, Latvia, Lithuania, Poland, Portugal and Slovakia were still required to apply the reduced withholding tax rates on interest and/or royalty payments as agreed in their tax treaties with other member states. That principle is expressly confirmed in the fourth paragraph of Article 6(1) of the Directive. In this respect, reference should also be made to the delimitation clause (Article 9 of the Directive) (see Chapter 21). **18.010**

C. ARTICLE 6(2) AND (3): HOME STATE CREDIT FOR SOURCE STATE TAX

Article 6(2) of the Directive is addressed to the home state of a company that receives interest or royalty payments that are subject to one of the transitional regimes described above (or the member state where a PE is situated that receives such interest or royalty payments). The provision was intended to prevent double taxation by requiring that member state to grant a tax credit **18.011**

7 Article 1 of Council Directive 2004/76/EC of 29 April 2004 amending Directive 2003/49/EC as regards the possibility for certain Member States to apply transitional periods for the application of a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 30 April 2004, p. 106-113.

8 Protocol concerning the conditions and arrangements for the admission of the Republic of Bulgaria and Romania to the European Union, OJ L 157, 21 June 2005, p. 29-202.

for the tax paid at source (i.e., in the Czech Republic, Greece, Spain, Latvia, Lithuania, Poland, Portugal or Slovakia).

18.012 However, Article 6(3) clarified that the credit to be granted was not a full credit, but an ordinary credit. That is to say, the home state was not required to grant a credit that was higher than that part of the tax on the recipient's income attributable to the interest or royalties under the home state's domestic law.

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ARTICLE 7: IMPLEMENTATION

Niels Bammens

1. **Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive not later than 1 January 2004. They shall forthwith inform the Commission thereof.**

   When Member States adopt these measures, they shall contain a reference to this Directive or shall be accompanied by such reference on the occasion of their official publication. The methods of making such a reference shall be laid down by the Member States.
2. **Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive, together with a table showing how the provisions of this Directive correspond to the national provisions adopted.**

COMMENTARY

A. INTRODUCTION

Article 7 governs the implementation of the Directive and, consequently, its temporal scope of application. The different implementation deadlines will be addressed below, followed by a brief discussion of the direct effect in the case of non-implementation. **19.001**

B. Implementation deadlines

The implementation deadline of the original 2003 Directive was 1 January 2004. The fifteen countries that were EU member states at the time were therefore required to bring into force the necessary legal provisions to transpose the **19.002**

Directive into national law by that date. As discussed in Chapter 18, however, Greece, Portugal and Spain were granted a delay for the implementation. The member states that acceded to the EU at a later date were required to bring into force the necessary implementing legislation by the date of their accession (although, as noted in Chapter 18, Section B.2, a deferment was granted to a number of new member states).

19.003 According to a survey carried out by IBFD in December 2005, the twenty member states that should have implemented the Directive by that time had done so in a timely manner, with the exception of Denmark, Estonia, Germany, Italy, Luxembourg, the Slovak Republic, and Sweden.[1] The results of the survey indicated that those member states adopted the necessary legislation at a later date to become effective retroactively from 1 January 2004 (although in the Slovak Republic the implementing legislation only became effective on 1 January 2005).

C. DIRECT EFFECT

19.004 The Court of Justice has consistently held that a Directive that has not been implemented (or has been incorrectly implemented) by a member state may have vertical direct effect.[2] That is to say, citizens can directly rely on the provisions of a Directive against a member state that has failed to (correctly) implement it into national law in a timely manner, on the condition that those provisions are unconditional and sufficiently precise.

19.005 It appears that the exemption granted under article 1(1) of the Directive is unconditional and sufficiently precise and therefore meets the conditions for having direct effect. Consequently, a taxpayer should be able to directly rely on that provision in situations where a member state has not (correctly) implemented that exemption into its national law.[3]

19.006 The same arguably applies to the right to refund and interest guaranteed under article 1(16) of the Directive (see Chapter 13). In 2014, a Belgian court of first instance decided an interesting case relating to the direct effect of that provision.[4]

1 IBFD, *Survey on the Implementation of the EC Interest and Royalty Directive*, available at https://taxation-customs.ec.europa.eu/system/files/2016-09/survey_ir_dir.pdf. The survey included five countries that had acceded to the EU in 2004 but did not include five member states that were entitled to a delay under a transitional regime. See also K. Eicker and F. Aramini, 'Overview of the recent development of the EC Directive on withholding taxes on royalty and interest payments' (2004) EC Tax Review, issue 3, 134.

2 E.g. Joined cases C-6/90 and C-9/90 Francovich [1991] ECLI:EU:C:1991:428.

3 Although there has been some debate about this question, on the different arguments, see L. Cerioni, 'Intra-EC Interest and Royalties Tax Treatment' (2004) European Taxation, 50-51.

4 BE: Arlon court of first instance 8 January 2014, No. 300101226, www.monKEY.be.

The case concerned a Belgian company that paid interest to a related French company. Although the interest qualified for an exemption from withholding tax under (the Belgian implementation of) the Directive, the Belgian company withheld tax at source at the rate of 10% (given that the standard domestic rate of 15% was reduced to 10% under the applicable tax treaty). Almost a year later, the Belgian company filed a claim with the Belgian tax authorities to obtain a refund of the tax that was erroneously withheld as well as interest on that amount.[5] The authorities agreed to a refund of the withholding tax but argued that no interest was due on that amount because article 1(16) of the Directive had not been implemented into Belgian law and because Belgian law did not provide for a payment of interest in a situation such as that at issue.[6]

Before the first instance court, the tax authorities took the position that article 1(16) of the Directive did not have direct effect because it was not unconditional (given that it referred to 'a rate corresponding to the national interest rate to be applied in comparable cases under the domestic law of the source State'). The court dismissed that argument and held that article 1(16) was unconditional and sufficiently clear to be given direct effect.[7] The mere fact that the provision refers to 'the national interest rate to be applied in comparable cases' did not change that conclusion. The Belgian company was therefore entitled to interest on the refund, calculated in accordance with the general rules on late payment interest on tax refunds. **19.007**

5 Note that the Belgian company relying on article 1(16) of the Directive was the debtor of the interest, while that provision only refers to "the receiving company or permanent establishment". On the relevance of that point, see K. Bronselaer, 'Rechtstreekse werking interest en royalty richtlijn levert interest op bij teruggaaf roerende voorheffing' (2014) Tijdschrift voor Fiscaal Recht, issue 463, 556.

6 In particular, the applicable provisions of Belgian law had the effect that no interest was due in cases where a withholding tax refund claim was introduced by the debtor of the income.

7 BE: Arlon court of first instance 8 January 2014, No. 11/432, para. 3.2: 'S'agissant du contenu de l'article 1, 16. de la directive n° 2003/49/CEE, celui-ci prévoit de manière précise et inconditionnelle, à l'expiration du délai d'un an laissé à l'Etat pour rembourser l'impôt retenu à la source, un droit à des intérêts sur l'impôt qui est remboursé à un taux correspondant au taux d'intérêt national applicable dans des cas comparables en vertu de la législation nationale de l'Etat d'origine. L'applicabilité directe de cette disposition est d'autant plus certaine qu'elle est clairement libellée en la forme d'un droit dans le chef du bénéficiaire de cette mesure. La circonstance que cette disposition renvoie à la législation nationale de l'Etat d'origine n'est pas de nature à remettre en cause cette interprétation et n'a pas pour conséquence que ledit Etat disposerait de la possibilité de refuser le bénéfice de la règle européenne en invoquant son propre droit interne' (author's translation: 'As regards the content of Article 1, 16. of Directive No. 2003/49/EEC, it provides in a precise and unconditional manner, upon expiry of the one-year period for the state to reimburse the tax withheld at source, a right to interest on the tax which is reimbursed at a rate corresponding to the interest rate applicable in comparable cases under the national legislation of the source state. The direct applicability of this provision is all the more certain since it is clearly drafted as a right for the beneficiary of the measure. The fact that this provision refers to the national legislation of the source state of origin does not call this interpretation into question and does not mean that the source state has the possibility of refusing the benefit of the EU law rule by invoking its own domestic law').

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ARTICLE 8: REVIEW

Niels Bammens

By 31 December 2006, the Commission shall report to the Council on the operation of this Directive, in particular with a view to extending its coverage to companies or undertakings other than those referred to in Article 3 and the Annex.

COMMENTARY

20.001 Article 8 of the Directive required the Commission to draft a report on the operation of the Directive by 31 December 2006. That requirement is in line with the statement in the preamble that the Commission was required to report to the Council "on the operation of the Directive three years after the date by which it must be transposed, in particular with a view to extending its coverage to other companies or undertakings and reviewing the scope of the definition of interest and royalties in pursuance of the necessary convergence of the provisions dealing with interest and royalties in national legislation and in bilateral or multilateral double-taxation treaties."[1] The Commission did not meet that deadline, but published the report in 2009.[2]

20.002 The Commission's report considered the timeliness and completeness of implementation by the member states, as well as interpretation issues and possible improvements to the existing text. Its general conclusion was that the

1 Recital 9 of the preamble to the Directive

2 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, COM(2009)179.

Directive was generally implemented in a timely and complete manner (on that point, see also Chapter 19) but that there was a need for guidance and coordination in respect of certain key concepts, as well as scope for improving the text of the Directive. For instance, the report referred to potential interpretation issues relating to the beneficial ownership criterion and the personal scope of application of the Directive. Those issues have been addressed earlier, in the Commentary on article 1 of the Directive (Chapter 13).

21

ARTICLE 9: DELIMITATION CLAUSE

Niels Bammens

This Directive shall not affect the application of domestic or agreement-based provisions which go beyond the provisions of this Directive and are designed to eliminate or mitigate the double taxation of interest and royalties.

COMMENTARY

21.001 Given the objectives of the Directive, it should not be surprising that it sets a minimum standard. That is to say, the Directive seeks to prevent or reduce double taxation in the specific situations to which it applies and under the specific conditions which it sets forth. It is possible that a member state's national law provides for relief from double taxation in situations not covered by the Directive. Obviously, the Directive does not affect the application of such rules.

21.002 Similarly, it is possible that a member state has concluded a tax treaty that contains more favourable relief provisions relating to interest or royalties. Again, the Directive obviously does not preclude the application of such treaty provisions.

22

ARTICLE 10: ENTRY INTO FORCE

Niels Bammens

This Directive shall enter into force on the day of its publication in the Official Journal of the European Union.

COMMENTARY

In accordance with article 297 TFEU, article 10 specifies the date on which the Directive entered into force. It states that the Directive entered into force on the day of its publication in the Official Journal, i.e., 26 June 2003. **22.001**

23

ARTICLE 11: ADDRESSEES

Niels Bammens

This Directive is addressed to the Member States.

COMMENTARY

23.001 Article 11 of the Directive requires little commentary. It states that the Directive is addressed to the member states of the EU. In line with the general rules of EU law, it is binding, as to the result to be achieved, upon each of them.[1]

23.002 Note that the application of transitional regimes in the context of the enlargement of the EU was discussed earlier, in the commentary on article 6 of the Directive.

23.003 Although it goes beyond the scope of the present book, it may be interesting to refer in this context to the agreement between the European Union and Switzerland providing for a number of measures equivalent to those laid down in the Directive.[2]

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1 Article 288 TFEU: 'A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods'.

2 Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, O.J. 2004 L 385/30. For a discussion, see e.g. K. Eicker and R. Obser, 'The impact of the Swiss-EC Agreement on intra-group dividend, interest and royalty payments' (2006) EC Tax Review, issue 3, 134.