3.2. EU Interest-Royalty Directive

3.2.1. Background and force

**Force**

The 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, i.e. the Interest-Royalty Directive, was issued on 3 June 2003. The directive has been in force from 1 January 2004. Member States had to bring into force the laws, regulations and administrative provisions necessary to comply with the directive no later than 1 January 2004. Qualifying interest and royalty payments made after this date come under the scope of the directive irrespective of the time under which the interest or royalty is considered to be accrued. The Interest-Royalty Directive, however, includes transitional rules concerning certain Member States.

**Objective**

The objective of the Interest-Royalty Directive is to ensure that intra-EU intragroup cross-border interest and royalty payments are subject to as beneficial tax treatment as applies to similar payments in one Member State. The cross-border payments must not lead to international double taxation and they must not be subject to more burdensome administrative formalities than payments in one Member State. The objective is to ensure that intragroup interest and royalty payments are taxed only once in a Member State. Because the objective of the directive could not be sufficiently achieved by the Member States, Union measures were considered necessary.

**Minimum requirements**

The Interest-Royalty Directive does not go beyond what was considered to be necessary in order to ensure that intragroup cross-border interest and royalty payments are not subject to a worse tax treatment than similar payments in one Member State. The directive does not affect the application of domestic or agreement-based provisions that go beyond the provisions of the directive and are designed to eliminate or mitigate double taxation of interest and royalty payments. Member States are free to exempt interest and royalty payments more broadly than required by the directive.

**Relevance**

The interest and royalty payments that come under the scope of the Interest-Royalty Directive are taxed only once in the state of residence of the income recipient. The source state, i.e. the state in which the qualifying intragroup intra-EU cross-border interest or royalty payment arises, must not tax the payment.

3.2.2. Tax treatment

3.2.2.1. Tax consequences

**Residence state**

The interest or royalty payments that come under the scope of the Interest-Royalty Directive are taxed only once in the state of residence of the income recipient or in the state in which the recipient has a permanent establishment. The fact whether and how much the residence or the permanent establishment state taxes, depends on the domestic tax law and the tax treaties of the state concerned.

**Source state**

Art. 1 of the Interest-Royalty Directive prohibits any taxes on the interest or royalty payments that come under the scope of the directive in the source state. The source state must not impose any taxes on the qualifying payments whether by deduction at source or by assessment. Any taxes levied in the source state on qualifying interest or royalty payments come under the scope of the prohibition, no matter of the name of the tax or the taxpayer.

If the payer and the recipient of an interest or royalty, however, are from the same Member State, the source state has a taxing right. The provision prohibiting any taxes in the source state does not prohibit the source state to take into account interest and royalty payments received by companies of that Member State, permanent establishments of those companies or permanent establishments situated in that state.

The EU Court has held that the prohibition to tax the qualifying payments concerns the taxes levied on the recipient of the payments and does not cover for example interest deduction limitations at the debtor level.

**Tax rate**

The Interest-Royalty Directive requires the source state to exempt the qualifying interest or royalty payments no matter what the level of taxes is in the state of residence of the recipient or in the state in which the recipient has a permanent establishment.
The directive, however, applies only if the recipient of the qualifying payment is the beneficial owner of the payment. A permanent establishment may qualify as the beneficial owner only if the payment is subject to a certain level of taxes in the state in which it is situated. In this way, in the case of permanent establishments, a certain level of taxes is required.

There is also a proposal for amending the *Interest-Royalty Directive* in a way that the source state would have to exempt the qualifying payments only if the payment was taxed in the residence state or in the permanent establishment state.

**Transitional provisions**

The *Interest-Royalty Directive* includes transitional provisions in relation to certain Member States. These Member States have the right to levy source-state taxes on the qualifying payments for a transitional period. The state of residence of the recipient of the payment taxed in the source state or the permanent establishment state can also tax the payment but it must allow a foreign tax credit for the taxes levied in the source state. The credit required is a normal credit, i.e. the credit must be allowed up to the taxes due in the state granting the credit. The tax levied in the source state does not need to be repaid to the taxpayer, even though the source-state tax would be higher than the tax in the residence state or in the permanent establishment state.

### 3.2.2.2. Administrative prerequisites

**Direct exemption**

The interest and royalty payments that come under the scope of the *Interest-Royalty Directive* must be exempt from tax immediately at the moment of the payment. It is not in accordance with the directive to first tax the payments and then later repay the tax on request of the taxpayer. Member States, however, may require taxpayers to comply with certain administrative formalities in order for them to benefit from the exemption.

**Attestation**

The source state has the right to require that the company or the permanent establishment making a request for a tax exemption provides attestation certifying that the company and the payment meet all the requirements of the *Interest-Royalty Directive* at the moment of the payment. If such attestation is not provided, the source state has the right to tax the payment.

According to Art. 1(13) of the *Interest-Royalty Directive*, the attestation presented by the taxpayer must be valid for 1-3 years from the date of issue and it must contain the following information:

- proof of the tax residence of the interest or royalty receiving company;
- where necessary, proof of the existence of a permanent establishment certificated by the tax authorities of the Member State in which the receiving company is a resident or in which the permanent establishment is situated;
- proof of the fact that the receiving company or the permanent establishment is the beneficial owner;
- proof of the fact that the company is subject to one of the taxes required by the directive;
- the required minimum holding or the criterion of a minimum holding of voting rights; and
- the period for which the required holding has existed.

Member States may also require information as to the legal basis of the payment, such as a loan contract or a licensing agreement.

**Exemption decision**

The source state may make it a condition for the exemption that it has issued a decision currently granting the exemption following an attestation certifying the fulfilment of the application requirements of the directive. The decision on exemption must be given within 3 months at most after the attestation and such supporting information as the source state may reasonably ask for has been provided. The decision must be valid for a period of at least 1 year after it has been issued.

**Expiry of the requirements**
If the requirements for the exemption cease to be met, the receiving company or permanent establishment must immediately inform the paying company or permanent establishment. If the source state so requires, the competent authority of that state must also be informed. [722]

3.2.2.3. Repayment of a tax levied in conflict with the directive

Claim

If the interest-or royalty-paying company or the permanent establishment has withheld tax in the source state even though the payment should be exempt, a claim may be made for a repayment of the tax. [723] In such a case, the source state may require proof that the payment meets all the requirements for application of the directive. [724] The application for the repayment must be submitted within a certain period, which must be at least 2 years from the date when the interest or royalty is paid. [725]

Repayment

The source state must repay the excess tax withheld in the source state within 1 year following due receipt of the application and the supporting information that may be reasonably requested. [726] If the tax has not been refunded within that period, the taxpayer company or the permanent establishment is entitled on expiry of the year concerned to interest on the tax at a rate corresponding to the national interest rate applied in comparable cases under domestic law of the source state. [727]

3.2.3. Intra-EU cross-border payment

Company or permanent establishment

Both companies and permanent establishments come under the scope of application of the Interest-Royalty Directive. The payment concerned, however, must be an intra-EU cross-border payment. The source state must not tax the interest or royalty payment if the beneficial owner of the payment is a company of another Member State or a permanent establishment of a company of a Member State situated in another Member State. [728]

Two Member States

Typically, a payment comes under the scope of application of the directive in the case of a payment from a subsidiary company that is a resident in one Member State to its parent company that is a resident of another Member State and vice versa.

A payment made between a parent company and a subsidiary that are residents in the same Member State may also come under the scope of the directive in a dual-residence conflict situation, even though there were no permanent establishments involved. The payment may come under the scope of the directive if one of the companies is considered to be a resident of another Member State because of the dual-residence conflict resolved by a tax treaty. Another Member State may be considered to be the state of residence, for example, if the place of management of one of the companies is situated in the other Member State.

Three Member States

The Interest-Royalty Directive also covers situations involving three Member States that are not covered by bilateral tax treaties. The directive covers situations in which a payment is made between a parent company and a subsidiary of two different Member States and the payment is connected with a permanent establishment of one of the companies situated in a third Member State.

In a dual-residence conflict situation the payment may also concern three Member States. A payment made between a parent company and a subsidiary company that are residents of two different Member States comes under the scope of the directive even if a third Member State considers one of the companies to be a resident in that third state.

Four Member States
A payment that comes under the scope of the Interest-Royalty Directive may sometimes concern four Member States. Four Member States may be involved if the payment is made by a resident company of one Member State but the payment is connected with a permanent establishment of that company in another Member State and the recipient of the payment is a resident company of a third state but the payment is connected with a permanent establishment of the recipient situated in a fourth Member State.

Payments excluded

Payments made inside one country do not come under the scope of the Interest-Royalty Directive. For example, a payment made by a company of a Member State to a company of another Member State does not come under the scope of application of the directive if the payment is connected with a permanent establishment of the receiving company situated in the state of residence of the paying company.

The directive also excludes payments made between companies of two different Member States that are connected with a permanent establishment of the payer or the recipient situated in a non-Member State. Permanent establishment situated outside the European Union do not come under the scope of the directive even though both the payer and the recipient would be residents in the European Union. Also, payments made by a permanent establishment of a company of a non-Member State are excluded from the scope of the directive even though the payment would be connected with a permanent establishment of the payer situated in the European Union.

Non-EU Member States

The Interest-Royalty Directive does not apply to payments between non-EU resident companies or permanent establishments outside the European Union and EU resident companies or permanent establishments in the European Union. The freedom of establishment principle included in the EEA Agreement, however, may require that similar benefits are made available to situations including a payer or payee company or a permanent establishment from an EEA State, provided that the company or the permanent establishment is comparable to the EU entity forms or permanent establishments covered by the directive. A non-EU Member State may also apply tax principles similar to the benefits provided by the directive based on a separate agreement.

3.2.4. Qualifying companies

3.2.4.1. Company of a Member State

Definition

Art. 3(a) of the Interest-Royalty Directive defines when a company of a Member State comes under the scope of the directive. The term “company of a Member State” means any company

– taking one of the forms listed in the Annex to the directive;

– 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 tax treaty with a non-Member State considered to be a tax resident outside the European Union; and

– which is subject to one of the taxes mentioned in Art. 3(a) of the directive without being exempt or to a tax which is imposed after the date of entry into force of the directive in addition to, or in place of, the existing taxes.

A company must meet all three requirements simultaneously in order to qualify as a company of a Member State for the purposes of the Interest-Royalty Directive. The company, however, does not need to meet all the requirements in one single Member State; it is sufficient that each of the requirements is met in one Member State.

Entity form

The list of the entity forms covered by the Interest-Royalty Directive and included in the Annex to the directive differs country by country. Typically, private and public companies limited by shares of different Member States come under the scope of application of the directive; otherwise, it depends on the Member State concerned which entity forms are covered.
In the case of some Member States, the Annex to the directive includes an expressive list of all the national entity forms covered. For example, national cooperative society forms may be included in the list of some Member States but not in the lists of all Member States. National partnership forms are usually not included in the list and in most situations they would fall outside the scope of the directive because they are not separately taxable entities.

Some Member States have not included an express list of all possible national entity forms in the Annex to the directive but they have determined broadly that all national company forms incorporated under the law of the state concerned come under the scope of the directive provided that the other two criteria set forth in Art. 3 of the directive are met. This type of a broad formulation is practical because it is less probable that this formulation leads to a treatment in conflict with the freedom of establishment principle than does the formulation including a list of the different national entity forms covered. It is possible that an express list of national entity forms covered excludes an entity that to some extent is similar to the entity forms covered, that the entity must be subject to the tax benefits similar to the benefits of the Directive in order for its tax treatment not to be in conflict with the freedom of establishment principle. However, a broad and general determination of the entities covered may be problematic in the way that it may lead to a conflict if the states involved interpret the term company differently.

It has been proposed that the scope of application of the Interest-Royalty Directive would be broadened to also cover expressly European Companies (SEs) and European Cooperative Societies (SCEs). Until the amendment, similar benefits based on the directive may have to be made available to European Companies and European Cooperative Societies and other comparable entities because of the freedom of establishment principle of the TFEU.

**Tax liability**

A company that comes under the scope of the Interest-Royalty Directive must be subject to one of the taxes of the EU Member States mentioned in Art. 3 of the Directive without being exempt.

Even if a company were to take an entity form listed in the Annex to the directive, the company does not qualify as a company of a Member State for the directive purposes if the company is tax exempt. Also, companies that are not separately taxable entities but are treated as partnerships based on a look-through approach fall outside of the scope of the directive. Hybrid entities that are treated as separate tax subjects in some Member States but as transparent entities in others are problematic from the perspective of the Interest-Royalty Directive. Hybrid entities, however, should come under the scope of the Directive if they fulfil the condition of being subject to a tax covered by the Directive in one of the Member States concerned.

**Tax residence**

A company that comes under the scope of the Interest-Royalty Directive must have its tax residence according to the domestic tax laws of a Member State in that state. The tax residence must not be in a non-Member State because of a tax treaty with a non-Member State.

**Dual-residence conflict**

A dual-residence situation, in which a company established and registered under the law of a Member State has its place of management in a non-member tax treaty state, usually falls outside the scope of the directive. A company does not come under the scope of the directive if the non-Member State treats the company as a resident and the tax treaty resolves the conflict in favour of the state with the place of management. These types of dual-resident companies are left outside of the scope of the directive because they may be used for the purposes of avoiding paying taxes in the European Union.

In principle, such dual-resident companies that have their residence in an EU Member State and in a non-member tax treaty state may come under the scope of the directive if the tax treaty resolves the conflict in favour of the EU Member State. According to most tax treaties a dual-residence conflict is resolved in favour of the EU Member State if the place of management of the company is in that state. The company, in such a situation, however, falls outside of the scope of the directive because the entity established outside the European Union does not take one of the entity forms listed in the Annex to the directive. The exceptional situation, in which a company is registered and established under the laws of a Member State and has its place of management in a non-Member State and the tax treaty between these states resolves the conflict in favour of the registration state, may come under the scope of the directive.

A dual-resident company that is considered to be a resident in two EU Member States comes under the scope of the Interest-Royalty Directive even if there was a tax treaty between the two Member States that resolves the conflict. If two Member States consider a company to be a resident, the company is considered to be a company of a Member State in both of the countries. The interest or royalty paid by this type of dual-resident company has two source states and both states must follow the directive requirements.
Also, a dual-resident company that is considered to be a resident in an EU Member State and in a non-Member State comes under the scope of the directive if there is no tax treaty between the states concerned. This type of dual-resident company is not in the same way problematic as companies of tax treaty states because there is no tax treaty that would prevent the EU state from taxing the profits of the company. It is, however, possible that the directive does not apply to this situation because the company has its place of management in the non-Member State, which constitutes a permanent establishment and the payment is considered to be connected with this permanent establishment outside the European Union.

### 3.2.4.2. Permanent establishment

**Directive definition**

Art. 3c of the Interest-Royalty Directive defines the term “permanent establishment” for the purposes of the 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.

**OECD Model**

The definition of the term “permanent establishment” included in the Interest-Royalty Directive is similar to the basic definition of the same term included in the first paragraph of Art. 5 of the OECD Model Convention. The Interest-Royalty Directive definition of the term “permanent establishment”, however, does not include similar specifications to the definition as Art. 5 of the OECD Model does in the following paragraphs.

For example, permanent establishments constituted by the activities of an agent are not mentioned in the Interest-Royalty Directive in the way that they are mentioned in the OECD Model. It is somewhat unclear whether this lack should be interpreted as meaning that a permanent establishment based on the activities of an agent does not constitute a permanent establishment for the purposes of the directive or that agent permanent establishments fall under the general definition included in the Interest-Royalty Directive. The activities of an agent should constitute a permanent establishment for the purposes of the directive if the presence of the agent in a Member State can be considered to fit under the general definition of the term “permanent establishment” under the directive. The agent and its activities, thus, must constitute a fixed place of business.

**Parent-Subsidiary Directive**

In contrast to the definition of the term “permanent establishment” included in Art. 3(2) of the Parent-Subsidiary Directive, the same definition included in Art. 3c of the Interest-Royalty Directive does not require that the permanent establishment is subject to taxes in the Member State in which it is situated. Because of the requirements set forth in Art. 1 of the Interest-Royalty Directive, the Interest-Royalty Directive, however, covers only such interest and royalty payments received by permanent establishments that are subject to tax in the permanent establishment state.

### 3.2.4.3. Associated companies

**Association**

According to Art. 1(7) of the Interest-Royalty Directive, the prohibition to levy taxes on a qualifying interest or royalty payment in the source state applies only if the payer and the recipient company are associated. The directive benefits 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 that is the beneficial owner of the payment, or whose permanent establishment is treated as the beneficial owner of the payment. The payment must be made between associated companies or permanent establishments of the associated companies.

**Two-year holding period**

Member States have the option of not applying the Interest-Royalty Directive to a company if the required association has not been maintained for an uninterrupted period of at least 2 years. A Member States may apply a shorter holding period requirement under domestic law but not a longer period. This option gives Member States the possibility to deny the directive benefits in the case of artificial arrangements.

The 2-year period requirement has been interpreted in the way that the requirement must be met at the moment of the payment of interest or a royalty. This interpretation is based on the wording of the Interest-Royalty Directive using the past tense. The wording of the similar option in the Parent-Subsidiary Directive is different and therefore has also been interpreted differently.

**Definition**
Art. 3b of the Interest-Royalty Directive defines when a company is considered to be an associated company for the purposes of the Interest-Royalty Directive. A company is an associated company of a second company if at least

- the first company has a direct minimum holding of 25% in the capital of the second company (vertical association); or

- the second company has a direct minimum holding of at least 25% in the capital of the first company (vertical association); or

- 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 (horizontal association).

Member States have the option to replace the criterion of minimum holding in the capital with that of a minimum holding of voting rights. [744]

Direct association

The source-state tax exemption based on the Interest-Royalty Directive applies in the case of interest or royalty payments made in any relation or in any direction between the associated companies. The payment may be made from the parent company to the subsidiary, from the subsidiary to its parent or from a sister company to a sister company, i.e. between two subsidiaries of the same parent company. Only a direct holding, however, qualifies, for which reason lower tier subsidiaries may not qualify as associated companies. For example, a payment between a parent company and its sub-subsidiary does not come under the scope of the directive. [745]

Company of a Member State

In most situations only companies of Member States are taken into account when determining the existence of the required association. [746] In the case of horizontal association, however, it seems possible that the common parent company of the two subsidiaries of two different EU Member States is from a non-Member State. [747] There are, however, no EU Court cases confirming this interpretation, which makes this interpretation uncertain. [748]

3.2.4.4. Beneficial owner

Relevance

The source state of interest or a royalty payment is required to exempt the payment only if the recipient of the payment is the beneficial owner of the payment. [749] This requirement limits the possibilities to use artificial arrangements and intermediaries by persons that would otherwise not come under the scope of the directive benefits.

Companies

According to Art. 1(4) of the Interest-Royalty Directive, a company of a Member State is considered to be the beneficial owner of interest or royalty if it receives the payment for its own benefit and not as an intermediary for some other person. For example, an agent, trustee or authorized signatory may be an intermediary, which is not the beneficial owner, even though it would be the legal owner of the income. The income-receiving company is the beneficial owner only if the company is the real economic owner of the income received.

The beneficial owner concept of the Interest-Royalty Directive is similar to the beneficial owner concept included in the OECD Model Convention, for which the interpretation of the OECD Model Convention term may be used as a guideline when interpreting the same term in the Interest-Royalty Directive. [750]

Permanent establishments

The Interest-Royalty Directive includes a separate definition of the term “beneficial owner” for the purposes of permanent establishments. The purpose of this separate definition is to avoid double non-taxation situations. According to Art. 1(5) of the Interest-Royalty Directive, a permanent establishment is considered to be the beneficial owner of an interest or a royalty only if

- the debt claim, right or use of information in respect of which interest or royalty payments arise is effectively connected with the permanent establishment; and
– the interest or royalty payment represents 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 the directive. [751]

The beneficial owner may be a permanent establishment if the debt claim, right or use of information is included as assets in the books of the permanent establishment or if the asset concerned is otherwise connected with the permanent establishment. [752]

If a permanent establishment of a company of a Member State is considered to be the beneficial owner, no other part of the company is treated as a beneficial owner. [753]

3.2.5. Source state

Company or permanent establishment

Art. 1(2) of the Interest-Royalty Directive determines the source state of an interest or royalty payment. A payment made by a company of a Member State or by a permanent establishment situated in another Member State is deemed to arise in that Member State. The Member State of the payer company or the permanent establishment is the source state.

Permanent establishment as payer

Art. 1(3) of the Interest-Royalty Directive determines when a permanent establishment is considered to be the payer of interest or a royalty. Accordingly, a permanent establishment is considered to be the payer only insofar as the payment represents a tax-deductible expense for the permanent establishment in the Member State in which it is situated. Only in such a case may the state in which the permanent establishment is situated be the source state of the interest or royalty payment.

If the interest or the royalty is not deductible in the state in which the permanent establishment is situated, the state in which the permanent establishment is situated is not the source state. The state, thus, is not bound by the directive and may tax the payment.

Company and permanent establishment as payer

Art. 1(6) of the Interest-Royalty Directive provides for a solution to such dual-source state situations in which both the state in which the permanent establishment is situated and the state of residence of the payer company seem to be the source state of the payment. The conflict is resolved in favour of the permanent establishment state. If the permanent establishment of a company of a Member State situated in another Member State is considered to be the payer, no other part of the company is considered to be the payer of the interest or the royalty. [754]

Dual-residence conflict

A dual-residence conflict involving two EU Member States does not cause a problem from the perspective of the determination of the source state for the Interest-Royalty Directive purposes. If the payer company is considered to be a resident of one Member State because of its place of registration and as a resident of another Member State because of the place of management, both of the states are considered to be source states for the purposes of the directive. Both states must refrain from taxing the payment. [755]

Unresolved conflicts

Even though the Interest-Royalty Directive provides for a solution for most dual-source state situations, certain conflicts remain unresolved. It is possible that a Member State cannot be considered to be the source state for the purposes of the Directive even though, according to the domestic law of that state, a source-state withholding tax must be levied on the interest or royalty payment concerned. It is possible that a source-state tax is levied in conflict with the objective and purpose of the directive. [756]

3.2.6. The concepts of interest and royalty

3.2.6.1. Interest

Definition

Art. 2a of the Interest-Royalty Directive defines the term “interest” for the purposes of the Directive. 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. In particular, the term “interest” means 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 are not regarded as interest. [757]

OECD Model
The definition of the term “interest” included in the Interest-Royalty Directive is largely similar to the definition of the same term included in Art. 11(3) of the OECD Model Convention. The difference is that the Interest-Royalty Directive definition does not mention government securities as does the OECD Model. This difference can be explained by the fact that a government is not a company covered by the directive.

### 3.2.6.2. Royalty

#### Definition

Art. 2b of the Interest-Royalty Directive defines the term “royalty” for the purposes of the directive. The term “royalty” means a payment 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, trademark, design or model, plan, secret formula or process. The term “royalty” also covers a payment of any kind received as a consideration for information concerning industrial, commercial or scientific experience. Also, payments for the use of, or the right to use, industrial, commercial or scientific equipment are regarded as royalties.

#### OECD Model

The definition of the term “royalty” included in the Interest-Royalty Directive differs slightly from the definition of the same term in Art. 12(2) of the OECD Model Convention. The definition of the Interest-Royalty Directive expressly covers payments for the use or for the right to use software, unlike the definition of the OECD Model. The definition of the Interest-Royalty Directive also covers payments for the use of, or the right to use, industrial, commercial or scientific equipment, unlike the most recent version of the OECD Model. [758]

### 3.2.6.3. Payments outside the scope of the directive

#### Profit distribution, repayment of capital or a hybrid

Even though an interest or a royalty payment would seem to be covered by the Interest-Royalty Directive, Member States are not obliged to allow the directive benefits in all situations. [759] Member States are free to leave such payments outside the scope of the directive benefits that are treated as profit distributions or as a repayment of capital according to the laws of the source state.

Also, income from certain hybrid instruments may be left outside the scope of the directive benefits. The source state may refrain from granting the benefits of the directive in the case of payments from debt claims that carry a right to participate in the debtor’s profits (profit participating loan), payments from debt claims that entitle the creditor to exchange its right to interest for a right to participate in the debtor’s profits (convertible bond) or payments from debt claims that contain no provision for repayment of the principal amount or where the repayment is due more than 50 years after the date of issue (perpetual debt).

Even though according to the Interest-Royalty Directive certain payments on hybrid instruments may be left outside of the scope of the directive benefits, it is possible that the source state must refrain from taxing the income because of the Parent-Subsidiary Directive. It is also possible that certain payments which have the characteristics of a profit distribution fall under the scope of both the Interest-Royalty Directive and the Parent-Subsidiary Directive.

#### Payments in excess of arm’s length level

The provisions of the Interest-Royalty Directive do not need to be applied in the case of a payment in excess of an arm’s length royalty or an arm’s length interest. [760] If by reason of a special relationship between the payer and the beneficial owner of a payment, or between one of them and some other person, the amount of the payment exceeds the amount which would have been agreed by the payer and the beneficial owner in the absence of such relationship, the provisions of the directive apply only to the later amount, i.e. to the arm’s length amount. The source state has the right to tax the amount that exceeds the amount that would have been agreed on between independent parties unless the Parent-Subsidiary Directive requires the payment to be exempt.

### 3.2.7. Tax-avoidance situations

#### Anti-avoidance

Art. 5(1) of the Interest-Royalty Directive includes an anti-avoidance provision. The directive does not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse. This anti-avoidance provision is similar to the anti-avoidance provision of Art. 1(2) of the Parent-Subsidiary Directive.

#### Tax avoidance purpose

According to Art. 5(2) of the Interest-Royalty Directive, Member States may withdraw the benefits of the directive or refuse to apply the directive in the case of transactions for which the principal motive or one of the principal...
motives is tax evasion, tax avoidance or abuse. This anti-avoidance provision is similar to the first sentence of the anti-avoidance provision included in Art. 15(1a) of the Merger Directive.

**Interpretation**

There are no decisions of the EU Court on how the anti-avoidance provision of the Interest-Royalty Directive should be interpreted and applied. There is, however, no reason to interpret the provision differently from the anti-avoidance provisions included in the Parent-Subsidiary Directive and the Merger Directive.

The directive benefits do not need to be made available in the case of a wholly artificial tax-avoidance arrangement used in order to benefit from the directive in a situation in which the directive benefits would not be available without the arrangement. The taxpayer, however, must be given the possibility to show that there are business reasons other than tax reasons for the arrangement before the directive benefits are denied. The application of the anti-avoidance provision must also always follow the proportionality principle.