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INSIGHT: Danish Court's Questions on Beneficial Ownership

BY OLIVER R. HOOR

The Court of Justice of the European Union has issued its decisions in six cases dealing with the interpretation of the EU Parent-Subsidiary Directive and the Interest and Royalties Directive.

For the purposes of the judgments, issued on February 26, 2019, the cases T Denmark (C-116/16) and Y Denmark Aps (C-117/16) regarding the interpretation of the Parent-Subsidiary Directive (PSD), and the cases N Luxembourg 1 (C-115/16), X Denmark A/S (C-118/16), C Denmark I (C-119/16) and Z Denmark ApS (C-299/16) regarding the interpretation of the Interest and Royalties Directive (IRD), have been joined.

The Facts

The Danish companies were all owned by a parent company resident in another EU member state (Luxembourg, Cyprus or Sweden). The EU parent companies were all directly or indirectly owned by companies resident in third countries or by private equity funds with unknown residency of the investors.

The Danish companies paid out either dividends or interest to their EU parent companies and claimed that such payments should be exempt from withholding tax in accordance with the PSD or the IRD.

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The Danish tax authorities claimed that the withholding tax exemptions following from the PSD and IRD should not be granted since the recipients (i.e. the EU parent companies) were not the beneficial owners of the payments.

The cases were appealed to the Danish High Court which referred questions to the CJEU.

The referred questions in the dividend and interest cases are generally the same. The question on beneficial ownership was only asked in the interest cases, as it is a requirement in the IRD that the recipient of interest payments is the beneficial owner thereof, whereas this is not a requirement in the PSD.

Questions Referred to CJEU

The questions referred by the Danish Court to the CJEU mainly concern three topics:

(i) The first topic relates to the existence of a legal basis enabling a member state to refuse to grant withholding tax exemptions on dividend and interest payments made to EU parent companies as provided in the PSD and the IRD. The question of the Danish Court further relates to the ''beneficial ownership'' concept in the IRD.

(ii) In so far as such legal basis exists, the second topic addressed concerns the constituent elements of any abuse of rights and the conditions for proving it.

(iii) The third topic, likewise in the event that it is possible for a member state to deny the benefits of the PSD and the IRD to an EU parent company, concerns the interpretation of the provisions of the Treaty on the Functioning of the European Union (FEU Treaty) relat-

 ISSN

ing to the freedom of establishment and the free movement of capital, in order to enable the referring court to establish whether the Danish legislation infringes those freedoms.

Need for Domestic or Agreement-based Anti-abuse Provisions?

Until the adoption of Law No. 540 of April 29, 2015, Danish tax law did not provide for any anti-abuse legislation. Therefore, the question has been raised by the Danish Court whether, absent a specific domestic or agreement-based anti-abuse provision, it was possible to deny the withholding tax exemptions provided in the PSD and IRD.

The CJEU states the general principle of EU law that a taxpayer cannot enjoy a right or advantage arising from EU law when the transaction at issue is purely artificial economically and is designed to circumvent the application of the legislation of the member state concerned.

Thus, when there is a fraudulent or abusive practice, the national authorities and courts should refuse to grant a taxpayer the withholding tax exemptions provided under the PSD and the IRD even if there are no domestic or agreement-based provisions for such a refusal. In addition, the withholding tax exemption on interest payments provided in the IRD is restricted to the beneficial owners of such interest.

The answer to this question is important to the Danish cases that go back as far as 2005, when the Danish tax law did not provide for any general anti-abuse rule. It is not surprising that the CJEU held that EU law cannot be relied on for abusive or fraudulent ends and benefits may be denied absent specific anti-abuse provisions.

However, this clarification has only a very limited impact for other cases since all EU member states have now implemented a general anti-abuse rule, at the latest since January 1, 2019 when the Anti-tax Avoidance Directive (ATAD) had to be implemented.

Proving the Existence of an Abusive Practice

In proving an abusive practice, the CJEU states two requirements:

- 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 consisting in the intention to obtain an advantage from the EU rules by artificially creating the conditions laid down for obtaining it.

According to the CJEU, the examination of a set of facts is needed to establish whether the constituent elements of an abusive practice are present and, in particular, whether economic operators have carried out purely formal or artificial transactions devoid of any economic or commercial justification, with the essential aim of benefiting from an improper advantage.

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 applicable tax law.

The presence of a certain number of indications may demonstrate that there is an abuse of rights, in so far as those indications are objective and consistent. Such indications can include, in particular:

- the existence of conduit companies which are without economic justification and must themselves pass the interest to a third company which does not fulfill the conditions for the application of the IRD;

- the purely formal nature of the structure of the group of companies, the financial arrangements and the loans.

The fact that a company acts as a conduit company may be established where its sole activity is the receipt of interest and its transmission to the beneficial owner or to other conduit companies. The absence of actual economic activity must, according to the CJEU, be inferred from the analysis of all the relevant factors relating, in particular, to the management of the company, to its balance sheet, to the structure of its costs and to expenditure actually incurred, to the staff that it employs, and to the premises and equipment it has.

Based on previous case law of the CJEU, the Court frequently rejects the presence of abuse in case a company has appropriate (as opposed to excessive) substance. In this regard, it is acknowledged that a holding and financing company that exists for legitimate commercial reasons might not need a lot of substance for properly managing its activities.

In addition, with regard to the burden of proof, the CJEU confirms that it is the task of the member state (or their competent authorities) to establish the existence of elements constituting an abusive practice while taking account of all the relevant factors, in particular the fact that the company to which the interest has been paid is not its beneficial owner.

Can a SICAR Benefit from the IRD?

In its decision, the CJEU also clarified that a SICAR (*société d'investissement en capital à risque*—an investment company in risk capital) established in corporate form (S.A., S.C.A., S.à r.l.) may not benefit from the withholding tax exemption on interest provided under the IRD since a SICAR benefits from a tax exemption on all its income (including interest) from investments in risk capital.

Do the Fundamental Freedoms Protect Fraud or Abuse?

The CJEU further states the obvious—that when a withholding tax exemption provided under the PSD or IRD is not applicable because there is found to be fraud or abuse, the application of the freedoms enshrined in the FEU Treaty (freedom of establishment, free movement of capital) cannot be relied on in order to call into question the legislation of the member state governing the taxation of the dividend or interest payments.

Interpreting the Beneficial Ownership Concept

With regard to the interpretation of the beneficial ownership concept as provided in the IRD, the CJEU ruled that member states cannot refer to concepts of national law that may vary in scope. This is consistent with the opinion of the Advocate General that called for an autonomous interpretation of the beneficial ownership concept in an EU context.

While the IRD subjects the withholding tax exemption to the condition that the beneficial owner of the income is established in another member state, or a permanent establishment situated in another member state and belonging to a company of a member state, the PSD does not include such requirement.

According to the CJEU, the concept of "beneficial owner of the interest" within the meaning of the IRD must be interpreted as designating an entity which actually benefits from the interest that is paid to it. Article 1(4) of the IRD confirms that reference to economic reality 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, such as an agent, a trustee or an authorized signatory for some other person.

The CJEU confirms that for the interpretation of the concept of beneficial ownership, EU member states may also consider the guidance provided in the Commentary to the Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital. The Court further clarifies that the mere fact that the company which receives the interest in a member state is not its beneficial owner does not necessarily mean that the exemption provided in the IRD is not applicable. Instead, if the beneficial owner that ultimately receives the income satisfies all the conditions of the IRD, the exemption has to be granted.

According to the opinion of the Advocate General, a recipient of interest income who collects the interest in its own name and on its own account (i.e. own benefit) is the beneficial owner. Assuming that the recipient of interest generally collects interest in its own name, the decisive question is whether that interest is being drawn on account or on behalf of a third party. A person who alone can decide on the appropriation of the interest and who bears the risk of loss is acting on its own account, while a person who is bound to a third party in such a way that the third party ultimately bears the risk of loss is acting on behalf of a third party.

A conduit company is not normally regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested party.

According to the Advocate General, a refinancing agreement concluded with a third party on similar terms and at a similar time as in the present case would not, of itself, suffice to assume that a trust relationship exists. Instead, more extensive ties would need to exist that limited the existing powers of the receiving company vis-à-vis third parties.

A company that performs financing activity should generally be considered as the beneficial owner of the interest income if the following conditions are met:

- the company bears the credit risk in relation to the financing activities;
- the company realizes an arm's length remuneration for the functions performed and the risks assumed. Thus, the amount of interest income should exceed the amount of interest expenses;
- the company may cover the costs incurred in relation to the financing activities;
- the company has no legal obligation to pass on the interest income to a third party. Ideally, it is clearly stated in the legal documentation that the finance company may freely enjoy the income, and the payment of interest expenses is subject to the approval by the board of directors;
- from a commercial perspective, it may also make sense to not negotiate identical terms (for example, different maturity, interest accrual periods) so as to reinforce beneficial ownership;
- from a practical perspective, the finance company may keep the funds for some time on its bank account. Nevertheless, a finance company needs to be careful not to incur too much costs in this respect since otherwise it might be difficult to cover the costs and to realize an arm's length profit.

With regard to dividend income, an EU parent company should be considered as the beneficial owner if the company has no legal obligation to pass on the income to a third party. Ideally, it is clearly stated in the legal documentation that the holding company may freely enjoy the dividend income and that the payment of interest or other payments under debt instruments financing the participation is subject to the approval of the board of directors. The parent company should keep the cash on its bank account until the directors of the company decide how to use the cash.

Conclusion

While it was not for the CJEU to assess the facts in the cases, the Court specified indicia of abusive or fraudulent acts and when an EU parent company may not be the beneficial owner of interest income, with a view to guide the Danish court in the assessment of the cases. In contrast, Advocate General Kokott analyzed in her opinion in which cases anti-abuse legislation should not apply and when EU parent companies should be considered as beneficial owners.

The approach taken by the CJEU in its decisions, describing situations where abuse might be present, rather than detailing when the benefits of the PSD and the IRD should be granted, creates the perception of a broad interpretation of abuse and fraudulent acts. In addition, some of the criteria mentioned by the CJEU seem to lower the threshold of abuse when compared to previous decisions (e.g. dividends are very soon after their receipt passed on by the EU parent company to entities which do not fulfill the conditions of the PSD) which is not helpful when it comes to legal certainty.

However, it can be assumed that the CJEU examined the same elements in previous cases when analyzing the existence of abusive or fraudulent acts and the compatibility of anti-abuse legislation in an EU context. In several judgments in 2017 and 2018, the CJEU reiterated its "wholly artificial arrangement" doctrine that the court systematically followed since the Cadbury Schweppes case in 2006 (see the cases Eqiom SAS (C-6/16), Deister Holding AG (Case C-504/16), Juhler Holding A/S (Case C-613/16) , GS v. Bundeszentralamt für Steuern (Case C-440/17).

Thus, national anti-abuse legislation must be targeted to prevent conduct involving the creation of "wholly artificial arrangements'' which do not reflect economic reality and the purpose of which is to unduly obtain a tax advantage.

Going Forward

It is now for the Danish courts to decide the cases in accordance with the guidance provided by the CJEU and the Court's previous case law. It might still take years until these cases are finally solved, given that appeals might be filed with the Danish Supreme Court.

Unfortunately, the present case law of the CJEU did not contribute much to certainty in times that are characterized by chronic legal uncertainty.

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