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Austrian Anti-abuse Legislation and EU Law: Compatibility Issues

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Dividends distributed by Austrian companies to EU parent companies may under certain conditions benefit from a withholding tax exemption. However, the application of this withholding tax exemption may be denied in accordance with Austrian anti-abuse legislation if the EU parent company does not comply with certain substance requirements.

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The EU Parent-Subsidiary Directive ("PSD") restricts EU member states in their right to levy withholding tax on dividend payments to corporate shareholders resident in other EU member states. The PSD has been designed to eliminate tax obstacles in the area of profit distributions between groups of companies in the EU by abolishing withholding taxes on payments of dividends between associated companies of different member states and preventing double taxation of parent companies on the profits of their subsidiaries.

Many EU member states, including Austria, implemented severe anti-Directive shopping rules that disallow the application of the withholding tax exemption on dividends if the parent company does not fulfil certain substance requirements. However, such anti-abuse legislation has to be consistent with EU Law as interpreted by the Court of Justice of the European Union ("CJEU").

In a decision of the CJEU of September 7, 2017, the court decided that a French anti-abuse provision (broadly similar to the principal purpose test ("PPT") under the 2017 version of the OECD Model Tax Convention) aiming at denying the benefits provided under the PSD was inconsistent with EU Law. On December 20, 2017, the CJEU decided that German anti-abuse legislation targeting PSD and tax treaty

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shopping was incompatible with EU Law. Both decisions emphasize that in an EU context anti-abuse legislation has to be specifically targeted at "wholly artificial arrangements." On this basis, it is possible to analyze whether the Austrian anti-abuse legislation is compatible with EU Law.

Applicable Austrian Tax Law

Dividends distributed by an Austrian company to a foreign parent company are generally subject to Austrian withholding tax at a rate of 25 percent (Section 93 (1), (1a) of the Austrian Income Tax Law ("AITL")).

However, dividends paid by an Austrian company to a parent company that is resident in an EU member state benefit from a tax exemption under the domestic implementation of the PSD if the following conditions are met (Section 94 No. 2 of the AITL):

- the parent company has (directly or indirectly) a participation of at least 10 percent in the share capital of the Austrian company; and
- such minimum participation is held for an uninterrupted period of at least one year.

In addition, the tax residency of the EU parent company has to be evidenced through a tax residence certificate that needs to be obtained from the tax authorities of the residence state of the company no more than 12 months before the moment of the distribution. So far, so good.

The application of the withholding tax exemption may, however, be denied in case of abusive directive shopping. In this regard, Section 94 No. 2 of the AITL provides that an Austrian company has to levy withholding tax in case a foreign company does not comply with certain substance requirements as specified in an Austrian regulation (Section 2 of the *Verordnung des Bundesministers für Finanzen zur Einbehaltung von Kapitalertragsteuer und deren Erstattung bei Mutter—und Tochtergesellschaften im Sinne der Mutter-Tochter-Richtlinie (StF: BGBl. Nr. 56/1995*). These requirements are meant to complement the Austrian general anti-abuse rule according to which an abuse of law may be challenged by the Austrian tax authorities.

More precisely, the relevant Austrian regulation states that an abuse of law within the meaning of Section 22 of the Austrian General Tax Code *(Bundesabgabenordnung*) would be the fault of the paying Austrian company unless the latter can provide a written statement of the parent company in which the following confirmations are made:

- the parent company performs an activity that is not limited to mere asset management;
- the parent company has its own employees;
- the parent company has its own premises.

In the absence of such written statement, the dividend withholding tax exemption will not be granted and the parent company has to claim a refund in accordance with the PSD. Otherwise, the Austrian company may be jointly liable for the withholding tax owed by the parent company if the Austrian tax authorities can evidence abusive directive shopping.

On the surface, this only means that the methodology of how the benefits provided under the PSD are granted shifts from the exemption method to a reclaim process. However, the non-application of the withholding tax exemption in accordance with the PSD and the shifting of the burden of proof onto the taxpayer may already be problematic from an EU Law perspective. Moreover, when examining the presence of abuse in the refund process, the Austrian tax authorities adhere to the aforementioned substance standard. Thus, in practice the Austrian tax authorities will deny the refund of withholding tax if the parent company does not meet all of these conditions.

Anti-abuse Legislation in an EU Context

Over the years, the CJEU has had to decide many cases related to the application of anti-abuse legislation in an EU context. One major decision was the *Cadbury Schweppes* case in 2006 (Case C-196/04: http://src.bna.com/yXQ) which firmly established the "wholly artificial arrangement" doctrine, limiting the scope of anti-abuse legislation in an EU context. However, over the last few years the question has been raised by many as to whether the CJEU would, in today's political environment, still be as restrictive as in the past.

Then, in two landmark cases involving German anti-abuse legislation (Cases C-504/16 and C-613/16, decision of December 20, 2017: http://src.bna.com/yXR; http://src.bna.com/yXS) and a PPT under French tax law (Case C-6/16, decision of September 7, 2017: http://src.bna.com/yXT), the CJEU re-emphasized its "wholly artificial arrangement" doctrine. In its decisions, the court analyzed the compatibility of anti-abuse legislation with the PSD and the freedom of establishment.

Considerations Regarding the Parent-Subsidiary Directive

According to Article 5 (1) of the PSD, the distribution of profits by a company that is resident in an EU member state to a parent company that is resident in another EU member state should be exempt from withholding tax. This exemption is meant to avoid double taxation, to ensure tax neutrality and to facilitate the grouping of companies at EU level.

Consequently, the PSD limits the sovereignty of EU member states regarding the taxation of profits distributed by resident companies to a parent company resident in another member state. Further, member states are not free to unilaterally introduce restrictive measures that would subject the right to exemption from withholding tax to various conditions.

Article 1 (2)–(4) of the PSD only allows member states to introduce domestic or agreement-based provisions required for the prevention of fraud and abuse provided that these measures are appropriate and do not go beyond what is necessary to achieve that objective. As an exception to the general rule laid down by the PSD, such measures are subject to a strict interpretation.

Considerations Regarding Freedom of Establishment

All measures which prohibit, impede or render less attractive the exercise of the freedom of establishment must be considered to be restrictions on that freedom. Such restrictions are only permissible if they relate to

situations which are not objectively comparable, or if justified by overriding reasons in the public interest recognized by EU law.

In these circumstances, it is further necessary that the restriction is appropriate for ensuring the attainment of the objective that it pursues and that it does not go beyond what is necessary to achieve this.

The Wholly Artificial Arrangement Doctrine

According to the CJEU, the objective of combating tax evasion and avoidance, whether it relies on Article 1 (2) of the PSD or is a justification for an exception to primary law (i.e., the freedom of establishment), has the same scope. Therefore, anti-abuse provisions have to be targeted measures aiming specifically at "wholly artificial arrangements" which do not reflect economic reality and the purpose of which is to unduly obtain a tax advantage.

Thus, tax authorities should not easily consider the presence of fraud or abuse. Moreover, taxpayers are free to rely on their EU freedoms when structuring investments, and "tax jurisdiction shopping" is a legitimate activity in an internal market, even if the choice of the jurisdiction is principally based on tax considerations.

It is, however, undisputed that member states are free to protect their tax bases by way of anti-abuse rules which are exclusively directed at wholly artificial arrangements. Nevertheless, when assessing the existence of fraud and abuse, tax authorities may not rely on predetermined general criteria. Instead, tax authorities have to carry out an individual examination of the whole operation at issue.

Analyzing the Substance of a Company

An abusive situation does not depend only on the intention of the taxpayer to obtain tax benefits (i.e., a motive test) but requires the existence (or absence) of certain objective factors, including an "actual establishment" in the host state (for example, premises, staff, facilities and equipment) and the performance of a "genuine economic activity." As regards the existence of an actual establishment, the CJEU does not seem to require an extensive level of substance. As a rule of thumb, the substance should be appropriate for the activities performed by the company.

The notion of "genuine economic activity" should be understood in a very broad manner and may include the mere exploitation of assets such as shareholdings, receivables and intangibles for the purpose of deriving what is often described as "passive" income. The nature of the activity should not be compromised if such passive income is principally sourced outside the host state of the entity.

When analyzing the substance of a company, it is necessary not only to analyze the situation of the entity as such but of the group as a whole. Here, it may even suffice if a company relies on the staff and premises of other group companies in the same jurisdiction. (As a reaction to the CJEU decision in regard to the German anti-abuse provision, the German Ministry of Finance released a Circular on April 4, 2018 in which it has been clarified that the provision according to which only the substance at the level of the direct parent company is to be considered is not applicable any more. Hence, it has been acknowledged that the substance of the entire group in the jurisdiction of the parent company needs to be taken into consideration when assessing potential cases of abuse.)

In addition, no specific ties or connections between the economic activity assigned to the foreign entity and the territory of the host state of that entity can be required by domestic anti-abuse provisions. Therefore, insofar as the EU internal market is concerned, the mere fact that an intermediary company is "active" in conducting the functions and assets allocated to it (rather than being a mere letterbox company) should suffice to be out of the scope of domestic anti-abuse legislation or the PPT in tax treaties concluded between EU member states.

Anti-abuse legislation should further not establish an irrebuttable presumption of fraud or abuse. Instead, the taxpayer must have the possibility to provide evidence of the appropriateness of the structure.

The imposition of a general tax measure automatically excluding certain categories of taxable persons from the tax advantage, without the tax authorities being required to provide even *prima facie* evidence of fraud and abuse, goes beyond what is necessary to prevent fraud and abuse. Accordingly, as long as the foreign company has appropriate substance, the nature (corporates vs. individuals), origin or tax status of their shareholder(s) should be irrelevant for the application of anti-abuse legislation.

From a practical perspective, the setting up of holding and finance companies with an artificially high level of equipment, facilities and employees would, however, to a certain extent, be contrary to their economic nature. The simple presence of a manager monitoring the holding and finance activities of the Luxembourg company may in some cases be considered sufficient to bring substance to the structure and, as such, prevent the structure from being (partially) disregarded due to the application of foreign anti-abuse provisions. A low level of substance is the direct consequence of the specific purpose of a "pure" holding and finance vehicle and should be accepted for tax purposes.

Analyzing Compatibility Issues

Based on the aforementioned CJEU case law, it is possible to analyze compatibility issues of the Austrian anti-abuse legislation with EU Law. The following aspects are problematic from an EU law perspective.

A Requirement for Employees and Premises

In order to benefit from a withholding tax exemption on dividends, an EU parent company of an Austrian company needs to have employees and premises. This suggests that a company would need at least two employees in order to benefit from the PSD. Based on experience, the Austrian tax authorities may refuse the application of the withholding tax exemption even when a parent company has several employees, albeit the interpretation of the regulation seems to slightly vary from one tax office to another. In this regard, the organizational, economic or other substantial features of undertakings that are affiliated with the nonresident parent company are not considered.

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These requirements pose comparability issues with EU Law for the following reasons:

- First, the substance of a company needs to be appropriate for the activities performed. When a company performs holding and financing activities, the management of the company's asset does not necessarily require a lot of substance. Moreover, certain functions (for example, accounting or tax compliance) may be outsourced to qualified service providers and reviewed by employees or directors of the parent company.
- Second, when analyzing the substance of a parent company, it is necessary to consider the situation of the entire group rather than the situation of the parent company in isolation.

A Requirement for an Activity that Exceeds Asset Management

According to the Austrian regulation, an EU parent company has to perform activities which exceed mere asset management. However, the CJEU made clear in its decisions that asset management is a legitimate business activity which suffices to enjoy the benefits of the PSD.

Rules not Targeted to Wholly Artificial Arrangements

When assessing the existence of fraud and abuse, tax authorities may not rely on predetermined general criteria. Instead, tax authorities have to carry out an individual examination of the whole operation at issue.

The imposition of a general tax measure automatically excluding certain categories of taxable persons from the tax advantage, without the tax authorities being required to provide even *prima facie* evidence of fraud and abuse, goes beyond what is necessary to prevent fraud and abuse.

Instead, national 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. Thus, a general presumption of fraud and abuse can justify neither a fiscal measure which compromises the objectives of the PSD nor a fiscal measure which prejudices the enjoyment of a fundamental freedom guaranteed by the EU Treaty.

To Sum Up

Several EU member states implemented anti-abuse legislation in their domestic tax law which requires excessive substance requirements and which is not consistent with the jurisprudence of the CJEU. The Austrian anti-abuse rules fall into this category, violating both the PSD and the freedom of establishment. It is self-evident that the Austrian anti-abuse rules are not specifically designed to target wholly artificial arrangements.

Actually, each of the formatted substance requirements is problematic from an EU Law perspective: the requirement for a parent company to have employees and premises as much as the requirement that the activities performed by the parent company need to exceed mere asset management.

The fact that the economic activity of a nonresident parent company consists in the management of its subsidiaries' assets or that the income of that company results only from such management cannot *per se* indicate the existence of a wholly artificial arrangement which does not reflect economic reality. This excludes not only letterbox companies from the benefits of the PSD but also holding companies that exist for a range of legitimate commercial reasons.

Planning Points

In light of the above, corporate shareholders resident in EU member states should systematically reclaim withholding tax levied on dividends paid by Austrian subsidiaries and challenge potential negative decisions before the Austrian courts. It is interesting to note that until today national courts around Europe have not deviated from the wholly artificial arrangement doctrine laid down by the CJEU.

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