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28 February 2019

CJEU clarifies abuse and beneficial ownership concepts under the Parent Subsidiary and Interest/Royalty Directives.

On 26 February 2019 the Grand Chamber of the Court of Justice of the European Union ("**CJEU**") rendered 2 important judgments regarding the non-application of the Parent Subsidiary Directive[1] ("**PSD**") and the Interest and Royalties Directive[2] ("**IRD**") in case of fraud or abuse, even in the absence of any domestic anti-abuse legislation. In this context, the judgements provide useful guidance on the concepts of abuse and beneficial ownership.

1st judgement in the joint cases C-116/16 and C-117/16 on the PSD

The 1st judgement was rendered in the joint cases C-116/16 and C-117/16 regarding the possible application of the PSD to exempt dividends paid by a Danish company to a Luxembourg or Cyprus parent company:

- In the 1st case[3], a Danish target company was initially purchased by a Danish company that was directly financed by several private equity funds not resident in the EU or in a jurisdiction that had concluded a double tax treaty with Denmark (*fig.1*). Further to a later restructuring, Luxembourg companies were interposed between the funds and the Danish target (*fig. 2*).

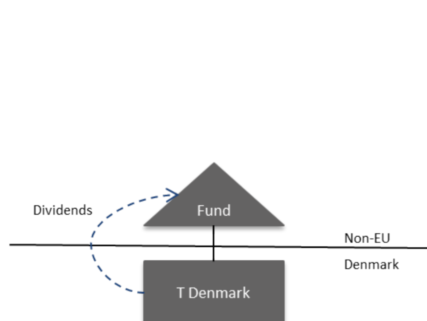

fig.1

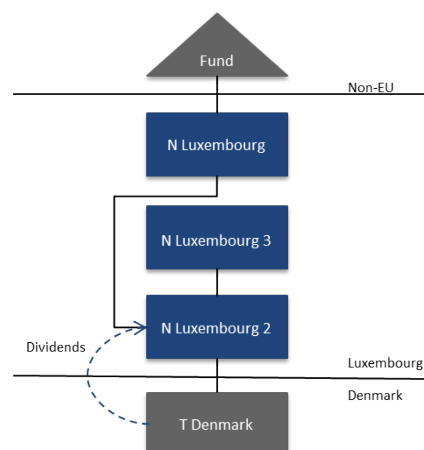

fig.2

[1] Council Directive 90/435/EEC – "PSD"
[2] Council Directive 2003/49 /EC – "IRD"
[3] C-116/16

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- In the 2nd case[4], the Danish distributing company was initially held directly by a Bermuda company which in turn was owned by a US parent (*fig. 3*). Prior to the distributions, the shares in the distributing Danish company were however transferred by the Bermuda company to a Cyprus company (*fig. 4*).

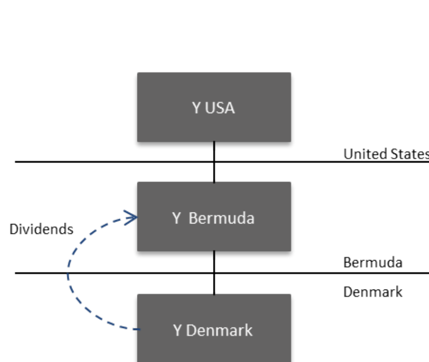

fig.3

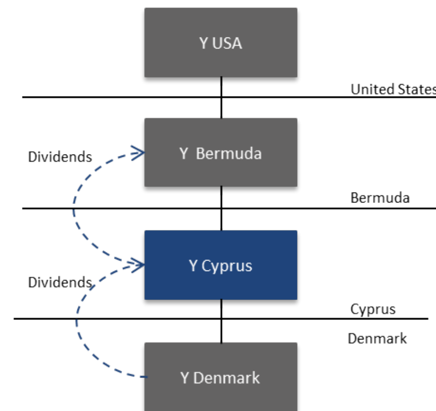

fig.4

In both cases, the question was raised whether the distribution could be exempt from the local Danish 28% dividend withholding tax under the PSD. The Danish authorities responded negatively to this question. The Danish National Tax Appeals Commission however took the view that the dividends should benefit from the exemption under the PSD as Denmark had not adopted legislative provisions to prevent fraud or abuse, as provided for by Article 1(2) of that directive, and consequently could not tax the dividends under domestic law. In that context, the Østre Landsret (High Court of Eastern Denmark) referred several questions to the CJEU for a preliminary ruling.

According to the CJEU, it is settled case-law that there is, in EU law, a general legal principle that EU law cannot be relied on for abusive or fraudulent ends[5]. While Article 1(2) of the PSD provides that the PSD does not preclude application of the domestic or agreement-based provisions required for the prevention of fraud or abuse, this provision cannot be interpreted as excluding the application of the general principle of EU law that abusive practices are prohibited. Taking into account this general principle, the Members States and national courts should deny the withholding tax exemption in case of fraudulent or abusive practices, even in the absence of domestic anti-abuse legislation, or anti-abuse legislation provided under tax treaties, allowing the exemption to be denied.

The CJEU points out that the pursuit by a taxpayer of the tax regime most favourable for it cannot, as such, set up a general presumption of fraud or abuse[6]. However, the fact remains that such a taxpayer cannot enjoy a right or advantage arising from EU law where the transaction at issue is purely artificial economically and is designed to circumvent the application of the legislation of the Member State concerned.

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[4] C-117/16

[5] Judgments of 9 March 1999, Centros, C-212/97, of 21 February 2006, Halifax and Others, C-255/02, 12 September 2006, Cadbury Schweppes and Cadbury Schweppes Overseas, C-196/04, 22 November 2017, Cussens and Others, C-251/16, 11 July 2018, Commission v Belgium, C-356/15

[6] Judgments of 12 September 2006, Cadbury Schweppes and Cadbury Schweppes Overseas, C-196/04, 29 November 2011, National Grid Indus, C-371/10, 24 November 2016, SECIL, C-464/14

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The proof of an abusive practice requires, first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by the EU rules, the purpose of such rules has not been achieved and, second, 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. The presence of a certain number of indications may demonstrate that there is an abuse of rights, in so far as these indications are objective and consistent. The CJEU mentions the following set of indications:

- the existence of conduit companies which are without economic justification and the purely formal nature of the structure of the group of companies, the financial arrangements and loans;
- an artificial arrangement consisting in a group of companies that is not set up for reasons that reflect economic reality, with a structure that is purely one of form and with a principal objective or one of its principal objectives being to obtain a tax advantage running counter to the aim or purpose of the applicable tax law;
- the interposition of a conduit entity between the distributing company and the beneficial owner of such distribution whereby payment of tax on the dividends is avoided; and
- the fact that all or almost all of the dividends are, very soon after their receipt, passed on by the recipient to entities which do not fulfil the conditions for the exemption (*i.e.* the aforementioned Bermuda company and the private equity funds).

The fact that a company acts as a conduit company may be established where its sole activity is the receipt of dividends and their transmission to the beneficial owner or to other conduit companies. The absence of actual economic activity must, in the light of the specific features of the economic activity in question, be inferred from an analysis of all the relevant factors relating in particular to:

- the management;
- the balance sheet;
- the structure of the costs and to expenditure;
- the staff; and
- the premises and equipment.

The CJEU however confirms that in a situation where the dividends would have been exempt had they been paid directly to the company having its seat in a third State, the aim of the group's structure is unconnected with any abuse of rights. In such a case, the group cannot be reproached for having chosen such a structure rather than direct payment of the dividends to that company.

In order to refuse to accord a company the status of beneficial owner of dividends, or to establish the existence of an abuse of rights, a national authority is not required to identify the entity or entities which it regards as being the beneficial owner(s) of those dividends.

Finally, the CJEU excludes reliance on the fundamental freedoms enshrined in the EU Treaty to exempt the dividends from the withholding tax at source in case of fraud or abuse.

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2nd judgement in the joint cases C-115/16, C-118/16, C-119/16, and C-299/16 on the IRD

The 2nd judgement was rendered in the joint cases C-115/16, C-118/16, C-119/16, and C-299/16 regarding the possible application of the IRD. In these cases, the Danish tax authorities denied the withholding tax exemption provided under the Interest and Royalties Directive for interest payments made by Danish companies to companies established in other Member States on the grounds that the recipients of the interest did not qualify as beneficial owners within the meaning of the IRD and that the structures were set up in an abusive manner in order to benefit from the exemption.

- In the 1st case[7], the Danish target company was initially purchased by a Danish company that was directly financed by several private equity funds not resident in the EU or in a jurisdiction that had concluded a double tax treaty with Denmark (*fig. 5*). Further to a later restructuring, Luxembourg companies were interposed while the first Luxembourg company's participation in the Danish company was partly financed by an issuance of Preferred Equity Certificates ("**PECs**") held by a second Luxembourg company which financed those in turn by a back-to-back PEC issuance to the funds (*fig. 6*). Hence, interest paid by the Danish subsidiary to the first Luxembourg company was immediately used by the latter to pay its own interest liabilities under its PECs. The *SKAT*[8] considered neither of the Luxembourg companies to be the beneficial owner of the interest and that the Luxembourg companies were merely acting as conduit companies.

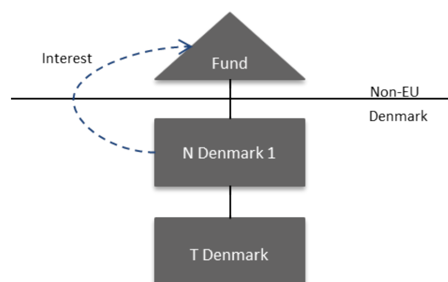

fig.5

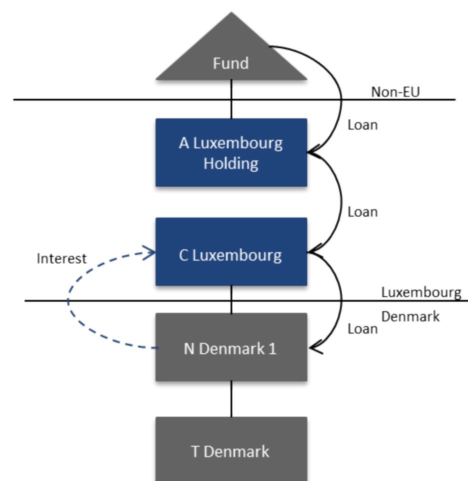

fig.6

- The 2nd case[9] concerned the acquisition of a Danish group by a Luxembourg investment company in risk capital ("**SICAR**") owned by a syndicate of private equity funds located outside the EU. The SICAR owned and funded a Swedish holding company, which in turn held a second Swedish company that held and funded the Danish target. Although interest paid by the Danish target to its Swedish lender was *per se* a taxable profit of the latter, the Swedish lender was entitled under local tax law to transfer such profit to its parent, such transfer being deductible and thus offsetting the taxable profit. In the hands of the Swedish parent, the taxable transfers were offset by interest under its own indebtedness towards the SICAR, which in turn benefitted in Luxembourg from an objective exemption on its profits derived from risk capital. The *SKAT* considered that neither the Swedish companies nor the Luxembourg company qualified as beneficial owner of the interest.

[7] C-115/16
[8] Danish tax authority
[9] C-118/16

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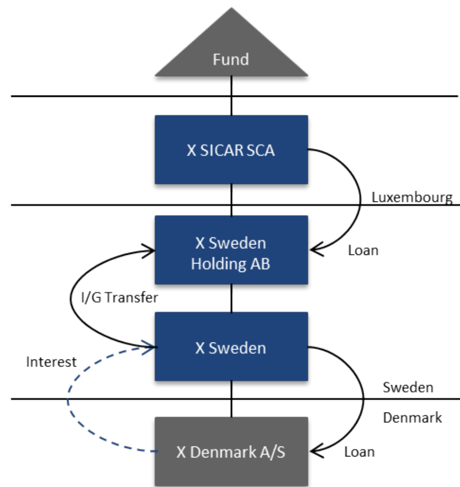
The question was whether a SCA SICAR would fall within the scope of the Interest and Royalties Directive.



- In the 3rd case[10], a Danish holding company was initially owned by a Cayman company of a US parent company (*fig. 7*). After a restructuring (*fig. 8*) two Swedish companies – a parent and a subsidiary – as well as a new Danish holding company – owned by the Swedish subsidiary – were interposed between the Cayman company and the former Danish subsidiary. The transfers were financed by loans granted by the Cayman company to the Swedish parent and loans granted by the Swedish subsidiary to the new Danish holding company. Although interest paid by the new Danish holding company to its Swedish lender was *per se* a taxable profit of the latter, the Swedish lender was entitled under local tax law to transfer such profit to its parent, such transfer being deductible and thus offsetting the taxable profit. In the hands of the Swedish parent, the taxable transfers were offset by interest under its own indebtedness towards the Cayman company. *The SKAT* considered that none of the Swedish companies were to be considered beneficial owners of the interest.

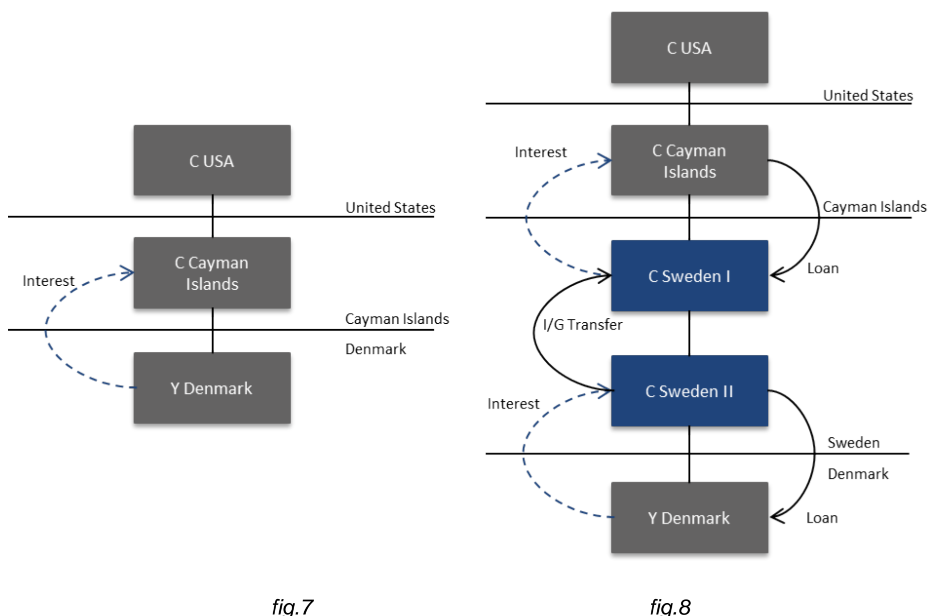


fig.7 *fig.8*

[10] C-119/16

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- In the 4th case[11], a Danish industrial company was partly acquired and financed by several funds established in Jersey (*fig. 9*). At a later stage, the financing was however routed through a newly incorporated Luxembourg company which was back-to-back financed by a loan granted by the funds (*fig. 10*). Accordingly taxable interest income was offset (save for an arm's length profit margin) by deductible interest expenses. The *SKAT* considered that the Luxembourg company was not the beneficial owner of the interest and that the IRD was therefore not applicable.

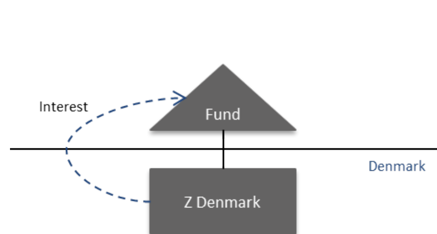

fig.9

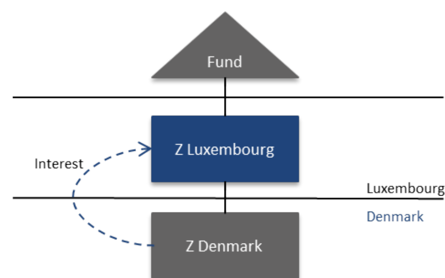

fig.10

The CJEU was requested again to deliver its opinion on the possibility (i) of denying the benefits of the IRD in abusive cases, absent any domestic anti-abuse provisions, and (ii) of excluding the application of the fundamental EU freedoms in such case, on which the CJEU reiterated its position taken in the 1st judgement (see above).

In addition, the CJEU was also requested to clarify the concept of "beneficial owner" within the meaning of the IRD.

The CJEU pointed out that the concept of "beneficial owner of the interest" in the IRD cannot refer to concepts of national law that vary in scope. The concept must be interpreted as designating an entity which actually benefits from the interest that is paid to it. The IRD confirms this 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, trustee or authorised signatory, for some other person. The term 'beneficial owner' concerns not a formally identified recipient but rather the entity which benefits economically from the interest received and accordingly has the power to freely determine the use to which it is put. Only an entity established in the EU can be a beneficial owner of interest for the purposes of the IRD and may then be entitled to the exemption provided for therein.

Furthermore, the IRD 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 to that model and to the commentaries relating thereto are therefore relevant when interpreting the IRD. Accordingly, 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 taxation to be avoided and tax evasion and avoidance to be prevented.

The CJEU however also stated 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 is not applicable. It is conceivable that such interest will be exempt on that basis in the source State when the company which receives it transfers the amount thereof to a beneficial owner which is established in the European Union and furthermore satisfies all the conditions laid down by IRD for the entitlement to such an exemption.

[11] C-299/16

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Incidentally, the CJEU was also asked whether a Luxembourg SICAR may benefit from the IRD. In this respect the CJEU concluded that, although all conditions for the application of the IRD are formally met by the SICAR, it cannot be regarded as being a "company of a Member State" within the meaning of the IRD if the interest received is in fact exempt from corporate income tax in Luxembourg.

Conclusion

The judgments have the merit of further clarifying the concept of beneficial owner and the abuse doctrine in the context of the IRD and the PSD. Moreover, the alignment of the beneficial owner concept with the OECD Model Tax Convention seems to be a sensible step towards the harmonisation of EU and international tax law.

The CJEU however seems to have misunderstood the *objective* tax exemption of the SICAR: contrary to a *subjective* tax exemption whereby the taxpayer is as such exempt from tax and is therefore not subject to any tax filings, a SICAR is subject to Luxembourg corporate income tax and must file annual tax returns. The SICAR only benefits from an *objective* tax exemption in respect of the income and gains realised on eligible securities in risk capital, in the same manner as ordinary companies may benefit from an *objective* exemption on qualifying dividends under the PSD.

The judgements further seem to broaden the definition of what constitutes tax avoidance under the PSD and the IRD. Contrary to previous case law where an arrangement was considered abusive only if the arrangement was wholly artificial[12], the CJEU seems to consider that it is sufficient for an arrangement to be considered abusive if the principal objective or one of the principal objectives of the arrangement is to obtain a tax benefit under the PSD or the IRD. It seems that the CJEU has adopted a dynamic approach and taken into account the OECD's commentaries regarding the principal purpose test ("**PPT**"), although at the time of the facts of these cases the OECD had not yet developed the PPT concept. According to the principal purpose test, tax treaty benefits should be denied if one of the principal purposes of an arrangement is to obtain that tax treaty benefit. Under the principal purpose test, it is important for a company, in order to be able to benefit from the tax treaty to be set up for valid economic reasons, to have a real business, to exercise substantive economic functions, to use real assets, to assume real risk and to have its own personnel.

This being said, it is noteworthy that in the cases at hand the taxpayers had amended their investment structures further to an unfavourable change in Danish domestic law and were not able to provide any economic rationale for such amendments other than tax reasons. The judgements therefore reiterate the importance of economic reasons for establishing an investment structure in a given jurisdiction as well as the functional profile of the various entities used.

The practical impact of these judgments may however be limited to the extent that in the meantime a specific anti-abuse provision has been introduced in the PSD and a general anti-abuse rule ("**GAAR**") has been introduced by the anti-tax avoidance directive ("**ATAD**"). Regarding transactions that would rely on double tax treaties, the PPT rule would most disqualify the relevant companies for treaty entitlements.

International taxation has significantly changed in the last years and these judgments are a clear reminder thereof. Existing investment structures using similar vehicles or techniques definitely need to be revisited. Our tax partners or your usual contact at Arendt & Medernach are of course at your disposal to assist you therewith.

[12] Deister Holding AG, C-504/16 and Juhler Holding A/S, C-613/16

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