C.J.E.U. JUDGMENTS ON DANISH BENEFICIAL OWNERSHIP CASES

Authors
Adnand Sulejmani
Thierry Lesage

Tags
C.J.E.U.
Denmark
M.N.E.

Thierry Lesage is a partner in the tax practice of Arendt & Medernach. He advises on both national and international tax issues and is active in private equity, real estate, and finance transactions.

Adnand Sulejmani is a tax associate in the tax practice of Arendt & Medernach where he advises private equity funds and multinationals on international and domestic corporate tax law issues.

INTRODUCTION

On February 26, 2019, the Court of Justice of the European Union ("C.J.E.U.") released two judgments[1] in a total of six cases dealing respectively with the interpretation of the E.U. Parent-Subsidiary Directive[2] ("P.S.D.") and the E.U. Interest & Royalties Directive[3] ("I.R.D.") (jointly referred to as the "E.U. Directives"). Under the E.U. Directives, dividends or interest paid by a company resident in a Member State to its parent company in a different Member State are exempt from withholding tax ("W.H.T."), provided certain conditions are met. The aim of the E.U. Directives is to favor the grouping of companies within the E.U. Single Market and to eliminate double taxation.[4] The E.U. Directives are often more favorable than the tax treatment reserved for dividends and interest in double tax treaties, which mostly provide a reduced W.H.T. Multinational groups operating within the E.U. structure their groups in such a way as to benefit from that W.H.T. exemption. The cases concluded that the E.U. Directives apply only in circumstances where the structure is not viewed to be abusive.

BACKGROUND

Briefly summarized, in all the cases addressed by the C.J.E.U., Danish-resident companies paid dividends or interest to their European parent companies, which were established in countries such as Cyprus, Luxembourg, or Sweden. The European parent companies were directly or indirectly owned by companies or by private equity funds resident in third countries with which Denmark had not concluded any double tax treaty. Based on the E.U. Directives, the Danish companies considered that collection of W.H.T. on the dividends or interest paid to their European parent companies was not required, as the conditions for the W.H.T. exemption were met.

---

1. C.J.E.U., February 26, 2019, Case C-116/16 (T Denmark) and Case C-117/16 (Y Denmark); C.J.E.U., February 26, 2019, Case C- 115/16 (N Luxembourg 1), Case C-118/16 (X Denmark), Case C-119/16 (C Denmark I) and Case C-299/16 (Z Denmark).
2. Council Directive 2011/96/EU of November 30, 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.
3. Council Directive 2003/49/EC of June 3, 2003, on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.
4. Contrary to the P.S.D., which eliminates both economic and juridical double taxation (*i.e.*, W.H.T. exemption and exemption from corporate income tax at the level of the parent company), the I.R.D. is designed to eliminate juridical double taxation only (*i.e.*, W.H.T. exemption).

However, some other relevant facts are of importance for the understanding of these two judgments. In all these cases, the interposition of European parent companies between the ultimate parents and the Danish companies lowered the tax burden on dividends and interest paid up the chain. The following circumstances could be observed in some or all of the cases:

- The activity of the European parent companies was limited to the management of their holdings and the granting of loans to their subsidiaries.
- They did not have their own office and had no (or very limited) staff.
- They realized very low margins and only a small portion of the dividends or interest received were kept in order to cover certain costs.
- The groups had undergone a restructuring in response to changes in domestic tax law. In the case involving a Cypriot company, the latter was set up and acquired the Danish subsidiary just a few days before a dividend payment.

In the case involving a Cypriot company, the latter was set up and acquired the Danish subsidiary just a few days before a dividend payment.

The Danish tax authorities were of the opinion that the Danish companies should have levied W.H.T. on the dividends and interest paid. The cases were brought in the Danish referring court, and in this context, the C.J.E.U. had to address the questions analyzed below.

GENERAL E.U. ANTI-ABUSE PRINCIPLE

Article 1(2) of the P.S.D. and Article 5(1) of the I.R.D. provide that "this directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse" (the "anti-abuse reservation"). These provisions give Member States the right to enact provisions in their domestic laws to restrict the application of the E.U. Directives in cases of abusive or fraudulent situations. Denmark did not exercise its right to enact an anti-abuse provision. At issue was whether it was necessary to have a specific domestic anti-abuse provision or an agreement-based provision to restrict the application of the E.U. Directives or whether a Member State could directly rely on Article 1(2) of the P.S.D. or Article 5(1) of the I.R.D. to deny the W.H.T. exemption.

On May 1, 2015, Denmark adopted a general anti-abuse rule ("G.A.A.R.") in its domestic law in anticipation of the E.U. Anti-Tax Avoidance Directive[5] ("A.T.A.D. I"), but Denmark did not have any similar statutory provision at the time when the dividend or interest payments in these cases were challenged by the Danish tax authorities. Until the adoption of the G.A.A.R. in 2015, there has been a long debate in Danish tax literature whether the "Reality Doctrine" (*Realitetsgrundsœtningen*) could be seen as a non-statutory G.A.A.R. to combat fraud and abuse.

In her opinion given to the C.J.E.U., Advocate General Kokott claimed that a Member State cannot invoke directly Article 1(2) of the P.S.D. or Article 5(1) of the I.R.D. without having transposed these provisions into domestic law and that it was for

[5] Council Directive (EU) 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

the referring Danish court to determine whether a general provision or principles of national law (including case law-based principles such as the Reality Doctrine) exist and enable the denial of the W.H.T. exemption. Further, Advocate General Kokott took the view that none of (i) Article 2(1)(c) of the Danish Corporate Tax Act (transposing the P.S.D.), (ii) Article 2(1)(d) of the same act (transposing the I.R.D.), and (iii) the beneficial ownership requirement under the double tax treaties can be deemed a transposition of Article 1(2) of the P.S.D. or Article 5(1) of the I.R.D., respectively.

"Member States are obliged to deny the W.H.T. exemption on the basis of the general E.U. law principle."

Nevertheless, the C.J.E.U. did not follow the Advocate General's opinion and stated that "it is settled case law that there is, in EU law, a general principle that EU law cannot be relied on for abusive or fraudulent ends." Hence, it is not necessary for a Member State to have any specific domestic provision or agreement-based provision in order to deny the W.H.T. exemption in cases of abuse or fraud. Based on that principle, the C.J.E.U. reached a contrary conclusion and stated that Member States are obliged to deny the W.H.T. exemption on the basis of the general E.U. law principle in such cases.

This appears to be a revision of the C.J.E.U.'s former position. In fact, in the *Kofoed* case,[6] the C.J.E.U. had held that a Member State may not invoke a directive-based provision (*i.e.*, the anti-abuse reservation) that has not yet been transposed into domestic law against an individual or a company. Nevertheless, the C.J.E.U. held in the present judgments, by specifically referencing the *Kofoed* case, that this should not mean that a Member State cannot rely on the general E.U. principles in order to deny the W.H.T. exemption.

From a practical perspective, the C.J.E.U.'s position on the above question will have little (if any) relevance in the future, taking into account the inclusion of a mandatory G.A.A.R. in the P.S.D. as well as the G.A.A.R. provided under A.T.A.D. I.

INTERPRETATION OF THE BENEFICIAL OWNERSHIP REQUIREMENT UNDER THE I.R.D.

The term "beneficial owner" is a concept originating from common law and was introduced into the dividends, interest, and royalties articles of the O.E.C.D. Model Tax Convention (the "Model Convention") in 1977.[7] It has been seen by many countries as the first response to treaty abuse or, more precisely, to treaty shopping. The concept continues to be heavily debated in international tax literature. Although it was held in the *Indofood* case[8] that beneficial owner should have an autonomous and international meaning, we can observe that countries go in one of two directions, giving the term either a formal interpretation or a substance-oriented interpretation.

Countries using a narrow and formal interpretation establish a very low threshold for beneficial ownership, thereby denying the treaty benefits to agents, nominees, and conduit companies that, due to a legal or contractual obligation, have no discretion

---

6 C.J.E.U., July 5, 2007, Case C-321/05.

7 Model Double Taxation Convention on Income and Capital, O.E.C.D., Paris, 1977.

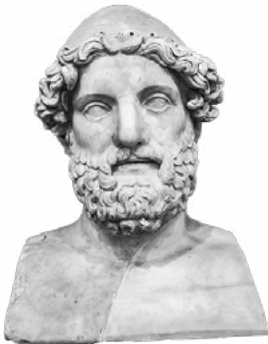
8 *Indofood International Finance Ltd. v. JP Morgan Chase Bank*, London Branch, [2006] EWCA Civ 158.

over the use of the income received. In other countries, the beneficial ownership requirement is based on a "substance-over-form" analysis, with a particular focus on economic control over the income received. In the latter approach, the income recipient has no control over the income received if there is a legal or contractual obligation to transfer the income to another person. Contrary to the formal interpretation, under the substance-over-form interpretation, it is possible that the obligation to pass on the income to another person might also be a mere factual obligation. Hence, the concept of beneficial ownership has different meanings across jurisdictions despite the O.E.C.D.'s attempt to draw the contours of this notion.

The income recipient must be the beneficial owner in order to benefit from the W.H.T. exemption under the I.R.D. The C.J.E.U. has provided guidance on the meaning of the term and on the relevance of the Model Convention and its commentaries for the interpretation of that term.

The C.J.E.U. has made it clear that when interpreting the concept of beneficial ownership no reference should be made to the meaning given in domestic law, as domestic law concepts might vary from one Member State to the other. Further, it appears from the translations of the I.R.D. in the different languages of the Member States that various expressions are used to designate the beneficial owner. Consequently, the term beneficial owner should receive an autonomous E.U. meaning, which might be different from the meaning given to that concept under a double tax treaty or domestic law.

According to the C.J.E.U., beneficial ownership should not be understood with reference to a formally identified recipient[9] but rather with reference to the person that benefits from the income received. The focus should be on the economic reality of the ownership, which is supported by Article 1(4) of the I.R.D. Consequently, an income recipient would only be considered the beneficial owner of the income if it receives the income for its own benefit and not as an intermediary, such as an agent, trustee, or authorized signatory, for some other person. It is, in this respect, crucial for the income recipient to have the power to freely determine the use to which the income is put. In order to benefit from the W.H.T. exemption provided under the I.R.D., the beneficial owner must be resident in the E.U., even if the direct income recipient – although an E.U. resident – is not the beneficial owner (the "look-through approach").



Having said that, it is worth mentioning that Advocate General Kokott suggested that the concept of beneficial ownership should be interpreted under E.U. law autonomously without regard to the commentaries on the Model Convention, as non-E.U. countries would otherwise have a say in the interpretation of the I.R.D. Nevertheless, the C.J.E.U. found that the Model Convention and its commentaries, as well as their successive amendments, are relevant when interpreting the concept of beneficial ownership in the context of the I.R.D. The C.J.E.U. has thus taken a dynamic approach to the meaning of the term beneficial owner, and any future amendments to the commentaries might reshape the meaning of that term.

The relevance of the Model Convention and its commentaries is justified by the fact that the 1998 I.R.D. proposal was inspired by Article 11 of the 1996 Model

---

[9] It is therefore not sufficient to be the legal owner – as foreseen under the domestic (civil) law of the country in question – of the assets from which the income is derived.

Convention, which has the same objective (*i.e.*, the avoidance of double taxation). Thus, when the C.J.E.U. makes reference to conduit companies that cannot be considered beneficial owners, it actually refers to companies that have only very narrow powers from a practical perspective, rendering them mere fiduciaries or administrators acting on account of the interested parties. Although these companies are the formal owners of the income, they are not the beneficial owners within the meaning of the commentaries on the Model Convention.

ABUSE UNDER THE E.U. DIRECTIVES

In these judgments, the C.J.E.U. clarified the constituent elements of an abuse of rights in the context of the P.S.D. or the I.R.D. In order to establish the existence of abuse, there must be:

> First, a combination of objective circumstances in which, despite formal observance of the conditions laid down by EU rules, the purpose of those 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.

In this context, the C.J.E.U. specified that it is necessary to examine facts on case-by-case basis in order to determine whether a specific situation is abusive. In this context, a particular focus should be put on whether the economic operators have created purely formal and artificial arrangements that are devoid of any economic and commercial justifications and aim essentially to benefit from an improper advantage. The C.J.E.U. laid down a certain number of indicators of abuse, but the C.J.E.U. specified that, even if these indicators are present, the taxpayer should have the opportunity to adduce evidence to the contrary.

In this context, the interposition of an entity between the entity paying the income and the beneficial owner, for instance, would be abusive if the interposed entity has not been 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 the W.H.T. exemption under the P.S.D. or the I.R.D. The C.J.E.U. clearly targets conduit companies that are not considered to be the beneficial owners of the income received.

Although the beneficial ownership requirement is expressly provided under the I.R.D., the condition is not contained in the P.S.D. Instead, the C.J.E.U. seems to hold that there is an implicit beneficial ownership requirement in the P.S.D. Moreover, it is somewhat misleading that the C.J.E.U. makes reference to the concept of "beneficial ownership" when analyzing "abuse" under the E.U. Directives, as these are two different concepts that should not be confused.

In addition, the C.J.E.U. notes that an indication of an artificial arrangement exists if an entity must quickly after receiving income pass that income on to another entity that does not fulfill the conditions for the W.H.T. exemption. Consequently, the tax authorities should examine whether an entity's sole activity is the receipt and transfer of income to the beneficial owner, thereby realizing only an insignificant margin on that activity.

An arrangement is also likely to be abusive in cases where an entity conducts no actual economic activity. In order to assess the existence or absence of actual

economic activity, an analysis must be performed of all the relevant factors, such as the management of the company, its balance sheet, the structure of its costs and expenditures actually incurred, the staff employed, and the premises and equipment of that entity. However, these factors are not similar if we compare, for instance, a pure holding activity with the activity of an operational entity. Consequently, that analysis has to be done in light of the features of the specific economic activity in question.

The artificiality of an arrangement may also be observed by analyzing the contracts existing between the companies involved in financial transactions in order to determine the way these transactions are financed, the valuation of the intermediary company's equity, and the latter's ability to have economic use of the income received. In this context, the C.J.E.U. held that the intermediary company might be legally or contractually obliged to pass the income received to another person, which would be an indication of an artificial arrangement. However, a legal requirement is not required in all instances as, in substance, the intermediary company may, in substance and from a factual perspective, be obliged to pass the income to another person even if no legal or contractual obligation exists to pass the income to another person.

The interpretation given by the C.J.E.U. to the term beneficial owner is in line with the commentaries of the 2017 Model Convention, which provide that the obligation to pass on the income might also be inferred from facts. However, given that the C.J.E.U. sticks to the commentaries of the Model Convention, an intermediary company involved into back-to-back financing should not be denied the status of a beneficial owner merely because it will pass the majority of the interest received to its parent company. In fact, the 2017 commentaries to the Model Convention clearly state:

> This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient . . . and which the direct recipient has as debtor.[10]

"An intermediary company involved into back-to-back financing should not be denied the status of a beneficial owner merely because it will pass the majority of the interest received to its parent company."

In some of the cases at hand, like the one involving the Cypriot company, the group had undergone, closely before or simultaneously to changes in the domestic tax law of the countries involved, a restructuring in order to mitigate the tax burden that the group would have faced would they not have undergone that restructuring (*i.e.*, abusive restructuring). This can be a further indication of an artificial arrangement.

In a controversial manner, the C.J.E.U. states that it "is also unsure" whether there can be an abuse of rights in case where the beneficial owner of the income is a company resident in a third state with which the source country has concluded a double tax treaty providing comparable benefits to dividends, interest, or royalties. In that set of circumstances, the income paid would have been exempt had the income been directly paid to that company without interposing another entity in-between. The C.J.E.U. continues and specifies that the existence of "such a convention" providing a W.H.T. exemption in case where the income is paid directly to the beneficial owner resident in a third state would not exclude *per se* the existence of abuse. Nevertheless, the C.J.E.U. concludes that the existence of such a convention may be an indication that the group structure is unconnected with any abuse of rights and that the group cannot be reproached to have chosen such a structure rather than

[10] Paragraph 10.2 of the commentaries on Article 11 of the 2017 Model Convention.

direct payment of the income.

With regard to dividends, the C.J.E.U. seems to consider that there is an implied beneficial ownership requirement within the P.S.D. It does not matter that the direct recipient is or is not the beneficial owner, as the dividends would be exempt in both instances. Consequently, as long as (i) the conditions of the P.S.D. are met and (ii) the beneficial owner is resident somewhere in the E.U. ("look-through approach").

In comparison, the W.H.T. exemption should not be granted where the beneficial owner of the income is resident outside the E.U. Although the P.S.D. does not expressly provide for a beneficial owner requirement, the C.J.E.U. considers that the P.S.D. was not designed to apply where the beneficial owner is resident outside the E.U. The C.J.E.U. justifies its position on the ground that the aim of the P.S.D. is the avoidance of economic and juridical double taxation within the E.U. However, if the dividends are exempt from W.H.T. in the source country, and assuming that the distributed income was exempt as earned by the distributing company, the distributed income would not have been taxed at all in the E.U, which is not the aim of the P.S.D.

Another interesting point addressed by the C.J.E.U. concerns the burden of proof. In this regard, the C.J.E.U. states that the taxpayer must provide evidence that the conditions of the E.U. Directives are met, upon request by the tax authorities. However, where the tax authorities consider the arrangement to be abusive, they need only to put forward elements indicating that the arrangement is abusive, for example that recipient is not the beneficial owner. The tax authorities have no obligation to identify the entity considered to be the actual beneficial owner. The C.J.E.U. considers that identifying the beneficial owner might be impossible in certain circumstances. Taking into account the look-through approach previously described, the taxpayer would need to establish that the beneficial owner is resident within the E.U. This entails a full showing of the identity of the beneficial owner and that the latter is resident within the E.U.

S.I.C.A.R. OUTSIDE OF THE SCOPE OF THE I.R.D.

The next question addressed by the C.J.E.U. was whether a S.I.C.A.R. (*société d'investissement en capital à risque*) set up in a corporate form and governed by Luxembourg law would qualify as a "company of a Member State" within the meaning of the I.R.D. A S.I.C.A.R. is a regulated vehicle governed by the Luxembourg law of June 15, 2004, relating to the investment company in risk capital. A S.I.C.A.R. can either be set up in a corporate form or in the form of a partnership. In case where the S.I.C.A.R. is established in a corporate form, the S.I.C.A.R. is subject to corporate income tax and municipal business tax in Luxembourg. Income derived by the S.I.C.A.R. from securities is exempt. The S.I.C.A.R. benefits thus from a partial objective exemption and not from a general subjective exemption.

Three requirements must be met in order to be qualified as a "company of a Member State" for purposes of the I.R.D. The first is whether the S.I.C.A.R. takes one of the corporate forms listed in the Annex of the I.R.D. The second is whether the S.I.C.A.R. is resident in Luxembourg. The third is that the company receiving the income must be subject to one of the taxes listed in Article 3 of the I.R.D. without having the option of being exempt. The C.J.E.U. focused on the third requirement.

While recognizing that a S.I.C.A.R. is subject to corporate income tax in Luxembourg, the C.J.E.U. held that the S.I.C.A.R. would not qualify as a company of a Member State if the interest received is actually exempt from corporate income tax. According to the C.J.E.U., the recital of the I.R.D. provides that the interest income must be subject to tax at least once in a Member State, which would be impossible because the interest income is exempt at the level of the S.I.C.A.R. Hence, the S.I.C.A.R. should not be viewed as a company of a Member State.

In the authors' view, the C.J.E.U.'s reasoning is incorrect and diverges from the Advocate General Kokott's opinion on that point. Advocate General Kokott concluded that the I.R.D. does not presently contain a "subject-to-tax" requirement. Indeed, the European Commission unsuccessfully attempted to amend the I.R.D. on that aspect.

The question then becomes whether the S.I.C.A.R. would also not be considered a company of a Member State for the purpose of the W.H.T. exemption for dividends provided under the P.S.D. Given that under both E.U. Directives, the income recipient must qualify as a company of a Member State, it could be argued that the same reasoning should be transposed. However, the objectives of the P.S.D. and the I.R.D. are not identical. The aim of the I.R.D. is to exempt interest payments from W.H.T. in the source country (*i.e.*, the elimination of juridical double taxation) provided that the beneficial owner is subject to income tax in the E.U. The aim of the P.S.D. is to eliminate economic (*i.e.*, the dividends are exempt from corporate income tax in the country of the recipient) and juridical double taxation (*i.e.*, the dividends are exempt from W.H.T. in the source country) at the level of the recipient of the dividend. Given that dividends received by a S.I.C.A.R are exempt from cor-porate income tax in Luxembourg (*i.e.*, economic double taxation is nonexistent), it remains only to eliminate the W.H.T (*i.e.*, the elimination of juridical double taxation) in the source country in order to achieve the objective of the P.S.D. For this reason a S.I.C.A.R. which is exempt in its residence country from corporate income tax on the dividends received should qualify as a company of a Member State for the purpose of the P.S.D.

FINAL REMARKS

Although the judgments have the merit to align the meaning of beneficial owner with the meaning given to that concept in the Model Convention, it is regrettable that the C.J.E.U. is mixing the concepts of abuse and beneficial ownership – which address different matters – in its reasoning. Even if an arrangement is not artificial and abusive, the income recipient may not be considered the beneficial owner of the income. Multinational groups operating within the E.U. should thus monitor the substance at the level of the income recipient and should make sure that the latter is not factually, legally or contractually bound to pass on the income to another person. In other words, the income recipient should be able to demonstrate that it has capacity and actually retains cash (*e.g.*, in order to embrace new business opportunities).

The beneficial owner concept no longer seems to be only relevant for the application of the I.R.D. Also in the context of the P.S.D., the income recipient, or any other group entity resident in the E.U. (*i.e.*, look-through approach), should be the beneficial owner of the dividends received in order to benefit from the W.H.T. exemption.

Further, the C.J.E.U. has broadened the definition of abuse under the P.S.D. and

the I.R.D. In prior cases, the C.J.E.U. always made reference to "wholly artificial arrangements" in order to define abusive situations. In the cases at hand, the threshold for abuse has been lowered, and it seems to be sufficient for an arrangement to be considered as being abusive if the principal objective or one of the principal objectives is to obtain a tax benefit under the E.U. Directives. This reasoning is similar to that of the principal purpose test ("P.P.T.") which has been recently introduced in the Model Convention. Application of the O.E.C.D. Multilateral Instrument (introducing the P.P.T. in many treaty situations among E.U. Member Countries) already has begun and tax authorities of the different Members State may rely on C.J.E.U. judgments when applying the beneficial ownership concept or the P.P.T.

Disclaimer: *This article has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.*