CJEU decision on the Beneficial Owner concept under the Interest and Royalties Directive and the Parent-Subsidiary Directive

On February 26, 2019, the Court of Justice of the European Union (CJEU) rendered two landmark decisions on the interpretation of the beneficial owner concept in cases where the Interest and Royalties Directive (joined cases N Luxembourg, X Denmark, C Danmark and Z Denmark) and the Parent-Subsidiary Directive (joined cases T Danmark and Y Denmark) apply. The CJEU concluded that it is for the referring courts to assess whether the arrangements under review constitute an abuse under EU law, taking into account in particular the existence of conduit companies.

Background

The four joined cases N Luxembourg 1 (C-115/16), X Denmark (C-118/16) and C Danmark 1 (C-119/16) and Z Denmark case (C-299/16) all involve back-to-back financing transactions, under which a Danish resident subsidiary is financed by its non-resident parent company via a series of loans granted to intermediary holding companies resident in another EU Member State. The two joined cases T Danmark (C-116/16) and Y Denmark (C-117/16) both concern dividend distributions made by a Danish resident company to an intermediate holding company resident in the EU.

In all cases, the Danish company requested an exemption from the Danish withholding tax levied on the payments made to the EU company, based respectively on the Interest and Royalties Directive (2003/49/EC) and on the Parent-Subsidiary Directive (90/435/EC). The Danish tax authorities denied the exemption, arguing that the company receiving the income was a conduit structure and could not be considered the beneficial owner of the payment.

The taxpayers appealed these refusals before the Danish courts. The Eastern and Western High Courts in turn asked the CJEU to clarify whether Denmark may deny the benefits of the EU Directives and impose withholding tax (1) on interest payments, based on the beneficial owner concept included in the Interest and Royalties Directive, and (2) on dividend distributions, based on the beneficial owner concept included in the Danish provisions implementing the Parent-Subsidiary Directive. The Courts also requested clarification of the applicability of the OECD's Commentaries on the Model Tax Convention in this respect, and on the requirements for a domestic or a tax treaty provision to qualify as anti-abuse provisions under the respective Directives.

The CJEU decision in the Parent-Subsidiary Directive cases

The CJEU first examined whether Denmark can rely on domestic or treaty-based anti-abuse provisions to combat an abuse under the Parent-Subsidiary Directive, if it has not transposed Article 1(2) of the latter. In this respect, the Court noted that EU law prohibits abusive or fraudulent practices as a general principle and concluded that in cases of abusive circumstances Denmark has to deny the benefit of an EU Directive, even in the absence of domestic or other anti-abuse provisions. Contrary to the Advocate General's (AG) Opinion, the Court concluded that in this case denying the benefit of an EU Directive merely results from the application of a general principle of EU law and therefore does not infringe the principle of legal certainty, which prohibits directives from being able by themselves to create obligations for individuals.

Noting that it is for the referring courts to assess whether the arrangements under review are in fact abusive, the Court nonetheless provided further guidance as to the constitutive elements of an abuse of rights under EU law. In accordance with settled case law, the Court concluded that an abusive situation can be evidenced in the combined presence of objective (the purpose of the EU Directives is circumvented, despite a formal observance of the conditions required for their application) and a subjective element (the intention to obtain benefits via a wholly artificial arrangement). In particular, the existence of a conduit company without economic substance, which cannot use or enjoy the income received but passes it on to a third party, could be considered an indication of a wholly artificial arrangement and hence of abuse. Relevant factors in identifying a conduit company are the management of the company, its balance sheet, the structure of its costs and the expenditure actually incurred, the staff it employs and its premises and equipment.
The fact that Denmark has concluded a tax treaty with the state of residence of the alleged ultimate beneficiary of the income cannot in itself rule out the existence of an abusive situation.

If abuse is identified, the Court further ruled, contrary to the AG's Opinion, that a Member State cannot be required to identify the person it deems to be the beneficial owner of the income, as it may be impossible for the national authorities to provide this information.

Lastly, the Court briefly addressed the potential infringement of the fundamental freedoms and concluded that the latter cannot be relied upon in abusive situations.

The CJEU decision in the Interest and Royalties Directive cases
The Court first noted that the exemption of interest payments from any taxes as provided for by the Interest and Royalties Directive is restricted solely to the beneficial owners of such interest and further emphasized that such beneficial owner is the entity that economically benefits and has the freedom to use and enjoy the interest. In this respect, the Court underlined that the OECD Model Tax Convention and the pertinent commentaries are relevant for interpreting the concept of beneficial owner under the Interest and Royalties Directive, as the original directive's proposal is based on the OECD work in this area.

Following a similar reasoning to that in the Parent-Subsidiary Directive cases, the Court further noted that the existence of an abuse under EU law should be assessed by the referring courts and provided additional guidance in that respect, similar to the guidance in the Parent-Subsidiary Directive cases. The Court also briefly addressed the potential infringement of the fundamental freedoms in an abusive situation, reaching the same conclusions as in the Parent-Subsidiary Directive cases.

Lastly, the Court addressed several questions on the general interpretation of the Interest and Royalties Directive that do not directly relate to abusive situations. Examining the case of the Luxembourg SICAR investment fund in the X Denmark case, the Court concluded that even if the SICAR is formally subject to corporate income tax in Luxembourg, it cannot benefit from the Directive if the interest income is in fact tax-exempt. Following settled case law as regards the Danish legislation possibly infringing the free movement of capital in non-abusive cases, the Court further noted that the Danish withholding tax on interest paid to non-residents infringed EU law insofar as resident taxpayers receiving Danish sourced interest (1) benefit from a tax payment deferral, (2) enjoy lower late payment interest rates and (3) may take any business expenses directly related to the interest income received into account when assessing their taxable income.

Meijburg & Co comments
The CJEU decisions indicate that it advocates a dynamic interpretation of terms and concepts in directives, as it took account of developments that had taken place after a directive was enacted. The 2003/2014 changes to the Commentaries to the OECD Model Convention, where these concerned the concept of beneficial ownership regarding conduit companies, were reflected by the CJEU. Therefore, such changes may not only affect the application of tax treaties but also the application of directives concerning direct taxes.

A minimum anti-abuse rule was included in the Parent-Subsidiary Directive with effect as of 2016, in order to address arrangements or a series of arrangements that do not reflect economic reality (see our December 2014 client memorandum). Nevertheless, the decision by the Court is important since it provides guidance on factors that are relevant in identifying a company as a conduit company and hence as wholly artificial and potentially abusive. The current Dutch substance requirements are in line with the factors identified by the Court.

The potential impact on the application of the Interest and Royalties Directive is, to a certain extent, more obvious as this Directive does not yet provide for such a minimum anti-abuse rule.
These judgments may also impact the Dutch ruling practice, which is currently under revision (see our November 2018 client memorandum). The revised ruling practice is expected to take effect as of July 1, 2019.

Meijburg & Co
February 2019