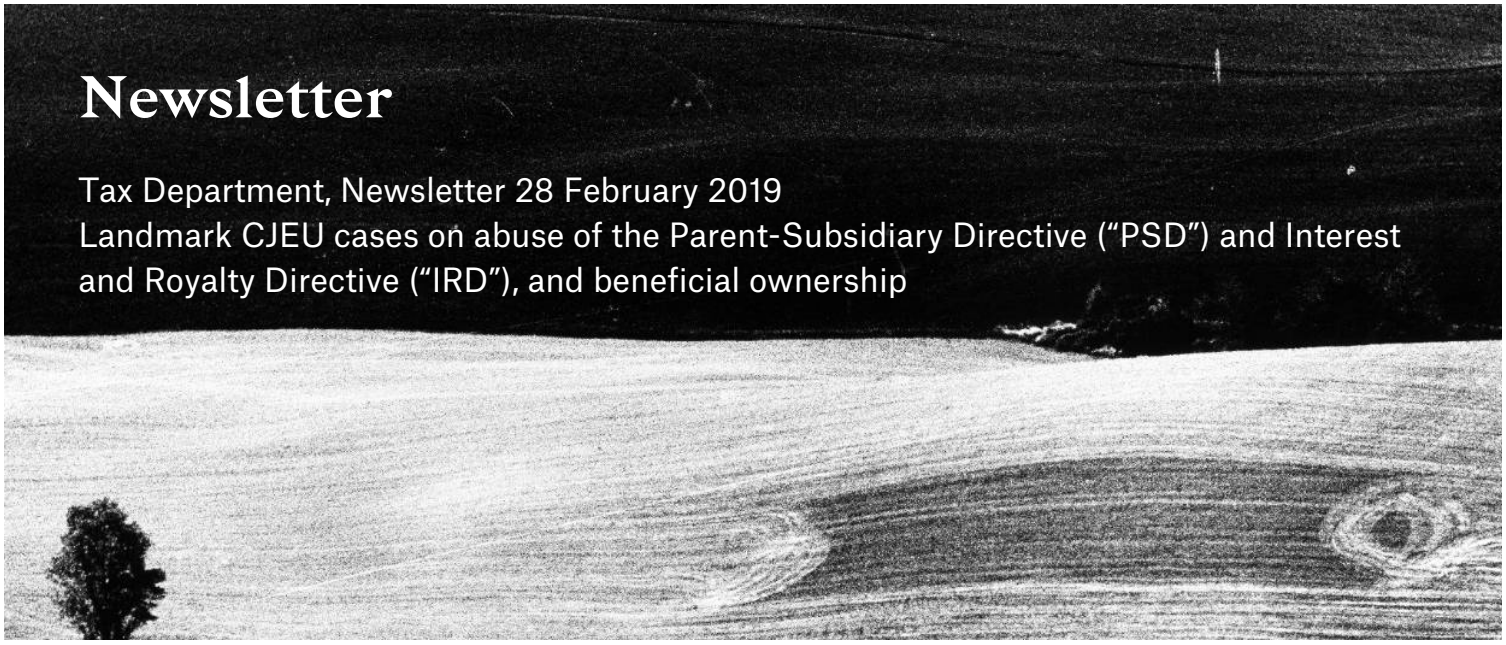
CHIOMENTI



Newsletter

Tax Department, Newsletter 28 February 2019
Landmark CJEU cases on abuse of the Parent-Subsidiary Directive ("PSD") and Interest and Royalty Directive ("IRD"), and beneficial ownership

Introduction

On 26 February 2019, the Court of Justice of the European Union ("**CJEU**") delivered two decisions on certain joined cases, *T Danmark* (C-116/16 and C-117/16, the "**PSD Cases**") and *N Luxembourg 1* (C-115/16, C-118/16, C-119/16 and C-299/16, the "**IRD Cases**" and, jointly with the PSD Cases, the "**Cases**"), dealing with the concepts of abuse of law within the PSD and IRD, and beneficial ownership.

The Cases concerned the denial of the exemption from Danish withholding taxes ("**WHTs**") on dividend and interest, granted by, respectively, the PSD and the IRD. Various fact patterns were put before the CJEU, but all involved EU parent companies entitled to PSD and IRD benefits, and ultimate companies up the control chain which were not.

The CJEU was asked, amongst the others: (I) whether a domestic or agreement-based anti-abuse rule is required in order to combat the abuse of EU rights; (II) what the constituent elements of abuse of rights are; (III) how the concept of beneficial ownership is to be interpreted; (IV) how the subject-to-tax requirement of the IRD has to be interpreted; and (V) whether EU Freedoms preclude WHTs on interest in certain cases.

I Whether a domestic or agreement-based anti-abuse rule is required in order to combat the abuse of EU rights

The CJEU declared that EU law encompasses a general legal principle that EU law cannot be relied on for abusive or fraudulent ends (para. 70 PSD Cases and para. 96 IRD Cases), which applies to all fields of EU law and is apparent from the case-law of the CJEU.

The fact that the PSD and IRD do not preclude Member States from laying down domestic or agreement-based anti-abuse provisions cannot be interpreted as defusing the general principle of EU law that abusive practices are prohibited (para. 77 PSD Cases and para. 104 IRD Cases).

The CJEU added that it is incumbent upon national authorities and courts to refuse to grant rights in circumstances of fraud or abuse (para. 82 PSD Cases and para. 110 IRD Cases). Accordingly, the absence of domestic or agreement-based anti-abuse provisions does not affect the national authorities' obligation to deny PSD and IRD benefits in those circumstances (para. 83 PSD Cases and para. 111 IRD Cases).

It is worth noting that at the EU level the Anti-Tax Avoidance Directive ("**ATAD**") now requires Member States to implement a General Anti-Avoidance Rule, which – prospectively – limits the impact of the Cases in this area.

II What the constituent elements of abuse are

Proof of abusive practices requires (i) the combination of an objective set of circumstances in breach of the purpose of the provision that is assumed to be abused and (ii) the subjective intention (notably, not the exclusive aim) of benefiting from the tax advantage without any other economic reasons (the so-called "two-prong test") (para. 97 PSD Cases and para. 124 IRD Cases).

An arrangement is artificial when it is not set up for reasons that reflect economic reality and is pure form (para. 100 PSD Cases and para. 127 IRD Cases).

It is for the national judge to assess all the relevant facts of an abusive conduct, but the CJEU provided useful indicia to this end, such as:

1) a recipient passes all or almost all of the dividends/interest it receives, very soon after their receipt, to entities which are not PSD/IRD entitled, with the consequence that the recipient makes an insignificant taxable profit (paras. 101 and 103 PSD Cases and paras. 128 and 130 IRD Cases);
2) the recipient's sole activity is the receipt of dividends/interest and their transmission to the beneficial owner (para. 104 PSD Cases and para. 131 IRD Cases);
3) the recipient is a conduit company with no economic use of the dividends/interest, legally or "in substance" (para. 105 PSD Cases and para. 132 IRD Cases); and
4) the above indicia are reinforced by the simultaneity or closeness in time of the entry into force of major new tax legislations, and the setting up of complex financial transactions and the grant of intragroup loans (para. 106 PSD Cases and para. 133 IRD Cases).

The burden of proof of assessing the facts of the abusive conduct lies with the tax authorities and the taxpayer must be admitted to the counter-proof (par. 99 PSD Cases and par. 126 IRD Cases). In their audit activity, tax authorities are not supposed to identify the "real" beneficial owners of the interest (paras. 142 and 143 IRD Cases).

On a different note, the CJEU held that the existence of a Double Tax Treaty between the Country of source of dividends/interest and that of the recipient cannot in itself rule out an abuse of rights (par. 108 PSD Cases and par. 135 IRD Cases). However, if the dividends/interest had been exempt under such a Treaty in a case of direct payment to the recipient located in a third Country, it remains possible to maintain that the aim of the group structure is unconnected with any abuse of rights (par. 110 PSD Cases and par. 137 IRD Cases).

III How the concept of beneficial ownership is to be interpreted

The IRD sets out an EU autonomous notion of "beneficial owner", that does not refer to concepts of national law. Notably, the beneficial owner of the interest is the entity that (i) benefits economically from the interest received, and therefore (ii) has the power to freely determine the use of such interest (paras. 84, 89 and 91 IRD Cases).

The OECD Model and Commentary, as amended from time to time, are relevant for the interpretation of this concept, since the IRD was drafted taking into account the OECD Model (para. 90 IRD Cases).

According to the reasoning of the CJEU, the benefits of the IRD should not be denied when the recipient of the interest is not the beneficial owner, but the actual beneficial owner fulfills the requirements of the IRD (para. 94 IRD Cases).

Further, the concept of beneficial ownership is dealt with also in the PSD Cases, where the CJEU held that the PSD benefits should be denied without any need to prove fraud or abuse when the actual beneficial owner of the dividend is resident in a third Country.

IV The subject-to-tax requirement of the IRD

A company that is liable to corporate tax but, at the same time, receives interest that is exempt from that tax does not qualify for the IRD: the purpose of the IRD is to ensure that interest is subject to tax at least once in a Member State, that of the recipient (paras. 151 and 152 IRD Cases).

As a consequence, the CJEU ruled that a Luxembourg SCA authorized as a SICAR cannot benefit from the exemption provided for by the IRD, if the SICAR is exempt from tax on the interest received (para. 153 IRD Cases): it is for the national judge to ascertain this.

In our view, a *de facto* non-taxation of the interest should not lead *per se* to a denial of the IRD benefits.

V Whether EU Freedoms preclude WHTs on interest in certain cases

The CJEU dealt also with certain questions concerning the potential violation of EU law of certain Danish laws.

Notably, the CJEU dealt with the compatibility of domestic laws according to which a resident company must apply a WHT on the interest paid to a non-resident company, no regard being due to the interest payable by such non resident company on any financing it may receive to fund its lending activity (para. 179 IRD Cases).

The CJEU held that where the benefits of the IRD are denied due to abusive practices, there is no possibility to claim EU Freedoms against domestic provisions (para. 155 IRD Cases).

If no abuse occurs, however, domestic laws as above violate EU free movement of capital, to the extent that interest on financing may be deducted by a resident company which receives interest from another resident company for the purpose of establishing its taxable income.

This holding is not surprising and in line with *Brisal* (CJEU, C-18/15, of 13 July 2016).

For any further clarification, please contact the Chiomenti Tax Department at the email address tax@chiomenti.net