26 February 2019

Global Tax Alert

CJEU rules on application of Danish withholding tax on dividends and interest payments

NEW! EY Tax News Update: Global Edition

EY's new Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Also available is our EY Global Tax Alert Library on ey.com.

On 26 February 2019, the Court of Justice of the European Union (CJEU) decided several cases dealing with Danish withholding tax on dividends and interest paid by Danish companies to companies in other Member States.[1]

Dividend cases

With respect to withholding tax on dividend distributions, the CJEU issued decisions in two cases. The first case, C-116/16, deals with a dividend distribution from a Danish company to a Luxembourg parent company that was indirectly owned by private equity funds through another Luxembourg company. The second case, C-117/16, deals with a dividend distribution from a Danish company to a Cyprus parent company which used the proceeds to repay interest and principal to its parent company in Bermuda which repatriated the income to the United States (US) parent company in the form of a dividend. In both cases, the main argument of the taxpayers was that Danish dividend withholding tax was not triggered by the distributions because of the participation exemption set forth in Article 5 of the European Union (EU) Parent and Subsidiary Directive (90/435). The CJEU has answered the questions raised by the Danish court as follows:

1. The general principle of EU law that EU law cannot be relied on for abusive or fraudulent ends must be interpreted as meaning that, where there is a fraudulent or abusive practice, the national authorities and courts are to

refuse a taxpayer the exemption from withholding tax on profits distributed by a subsidiary to its parent company, provided for in Article 5 of the Directive, even if there are no domestic or agreement-based provisions providing for such a refusal.

2. It is left for the national court to determine whether the arrangement of a particular case amounts to an abuse of law. Proof of an abusive practice requires, first, a combination of *objective* circumstances in which, despite formal observance of the conditions set forth by the 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. Examination of a set of facts is therefore needed to establish whether the constituent elements of an abusive practice are present, and in particular whether economic operators have carried out purely formal or artificial transactions devoid of any economic and commercial justification, with the essential aim of benefiting from an improper advantage. The CJEU further noted that a group of companies may be regarded as being an artificial arrangement where it is not 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 a tax advantage running counter to the aim or purpose of the applicable tax law. That is so, inter alia, where, on account of a *conduit entity* interposed in the structure of the group between the company that pays dividends and the company in the group which is their beneficial owner, payment of tax on the dividends is avoided. In the view of the CJEU the following facts may indicate the existence of an arrangement intended to obtain improper entitlement to the exemption provided for in Article 5 of Directive 90/435:
   - That all or almost all of the dividends are, very soon after their receipt, passed on by the company that has received them to entities which do not fulfil the conditions for the application of Directive, either because they are not established in any Member State, or because they are not incorporated in one of the forms covered by the Directive, or because they are not subject to one of the taxes listed in the Directive, or because they do not have the status of "parent company" and do not meet the conditions set forth in Article 3 of the Directive.
   - The company which receives the dividends paid by the debtor company must itself pass those dividends on to a third company which does not fulfil the conditions for the application of the Directive, with the consequence that it makes only an insignificant taxable profit when it acts as a conduit company in order to enable the flow of funds from the debtor company to the entity which is the beneficial owner of the sums paid.
   - 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 of the company, to its balance sheet, to the structure of its costs and to expenditure actually incurred, to the staff that it employs and to the premises and equipment that it has.
   - Indications of an artificial arrangement may also be established by the various contracts existing between the companies involved in the financial transactions at issue, giving rise to intragroup flows of funds, by the way in which the transactions are financed, by the valuation of the intermediary companies' equity and by the conduit companies' inability to have economic use of the dividends received. In this connection, such indications are capable of being constituted not only by a contractual or legal obligation of the parent company receiving the dividends to pass them on to a third party but also by the fact that "in substance," as the referring court states, that company, without being bound by such a contractual or legal obligation, does not have the right to use and enjoy those dividends.
   - Such indications may be reinforced by the simultaneity or closeness in time of, on the one hand, the entry into force of major new tax legislation, such as the Danish legislation at issue in the main actions, and, on the other hand, the setting up of complex financial transactions and the grant of intragroup loans.
   - When examining the structure of the group, it is immaterial that some of the beneficial owners of the dividends paid by the conduit company are resident for tax purposes in a third State which has concluded a double taxation convention with the source Member State. The existence of such a convention cannot in itself rule out an abuse of rights. Thus, a convention

of that kind cannot call into question that there is an abuse of rights where its existence is duly established on the basis of a set of facts showing that economic operators have carried out purely formal or artificial transactions devoid of any economic and commercial justification, with the essential aim of benefiting improperly from the exemption from withholding tax, provided for in Article 5 of the Directive.

- It remains possible, 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, that 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.

3. It is in principle for the companies which seek entitlement to the exemption from withholding tax on dividends to establish that they fulfil the objective conditions imposed by the Directive. On the other hand, where a tax authority of the source Member State seeks, on a ground relating to the existence of an abusive practice, to refuse to grant the exemption to a company that has paid dividends to a company established in another Member State, it has the task of establishing the existence of elements constituting such an abusive practice while taking account of all the relevant factors, in particular the fact that the company to which the dividends have been paid is not their beneficial owner. However, such an authority is not required to identify the beneficial owners of those dividends but of establishing that the supposed beneficial owner is merely a conduit company through which an abuse of rights has been committed.

4. In a situation where the system, laid down by the Directive, of exemption from withholding tax on dividends paid by a company resident in a Member State to a company resident in another Member State is not applicable because there is found to be fraud or abuse, application of the freedoms enshrined in the Treaty on the Functioning of European Union (TFEU) cannot be relied on in order to call into question the legislation of the first Member State governing the taxation of those dividends.

Interest cases

With respect to withholding tax on interest payments, the CJEU issued decisions in four cases. Three cases, C-115/16, C-118/16 and C-299/16, deal with private equity funds that have granted loans to Danish companies through intermediary Luxemburg companies. The fourth case. C-119/16, deals with a US multinational group where a Cayman company had granted loans to a Swedish company which had granted loans to a Danish company. In all cases, the main argument of the taxpayers was that Danish interest withholding tax was not triggered by the interest because of the exemption set forth in Article 1 of the EU Interest and Royalty Directive (2003/49). The CJEU has answered the questions raised by the Danish courts as follows:

1. The concept of "beneficial owner of the interest," within the meaning of the Directive, must be interpreted as designating an entity which actually benefits from the interest that is paid to it. The concept of "beneficial owner," which appears in the bilateral tax treaties based on the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention, and the successive amendments of that model and of the commentaries relating thereto are, relevant when interpreting the Directive.

2. The general principle of EU law that EU law cannot be relied on for abusive or fraudulent ends must be interpreted as meaning that, where there is a fraudulent or abusive practice, the national authorities and courts are to refuse to grant entitlement to rights provided for by the Directive, even if there are no domestic or agreement-based provisions providing for such a refusal.

3. It is left for the national court to determine whether the arrangement of a particular case amounts to an abuse of law. This must be determined based on the same criteria as mentioned above regarding the dividend cases.

4. It is in principle for the companies which seek entitlement to the exemption from withholding tax to establish that they fulfil the objective conditions imposed by the Directive. On the other hand, where a tax authority of the source Member State seeks, on a ground relating to the existence of an abusive practice, to refuse to grant the exemption to a company that has paid interest to a company established in another Member State, it has the task of establishing the existence of elements constituting such an abusive practice while taking account of all the relevant factors, in particular the fact that the company to which the interest has been paid is not the beneficial owner. However, such an authority is not required to identify the beneficial owners of such interest but of establishing that the supposed beneficial owner is merely a conduit company through which an abuse of rights has been committed.

5. An SCA company authorized as a SICAR governed by Luxembourg law cannot be classified as a company of a Member State, within the meaning of the Directive, capable of being entitled to the exemption provided for in the Directive if, a matter which is for the referring court to ascertain, the interest received by that SICAR, in a situation such as that at issue in the main proceedings, is exempt from corporate income tax in Luxembourg.
6. In a situation where the system of the Directive of exemption from withholding tax on interest paid by a company resident in a Member State to a company resident in another Member State is not applicable because there is found to be fraud or abuse, application of the freedoms enshrined in the TFEU cannot be relied on in order to call into question the legislation of the first Member State governing the taxation of that interest.
7. If no fraud or abuse is found to exist, Article 63 of the TFEU must be interpreted as follows:
    - Article 63 is not precluding, in principle, national legislation under which a resident company which pays interest to a nonresident company is required to withhold tax on that interest at source while such an obligation is not owed by that resident company when the company which receives the interest is also a resident company. However, Article 63 precludes national legislation that prescribes such withholding of tax at source if interest is paid by a resident company to a nonresident company while a resident company that receives interest from another resident company is not subject to the obligation to make an advance payment of corporation tax during the first two tax years and is therefore not required to pay corporation tax relating to that interest until a date appreciably later than the date for payment of the tax withheld at source.
    - Article 63 precludes national legislation under which the resident company that owes the obligation to withhold tax at source on interest paid by it to a nonresident company is obliged, if the tax withheld is paid late, to pay default interest at a higher rate than the rate which is applicable in the event of late payment of corporation tax that is charged, inter alia, on interest received by a resident company from another resident company.
    - Article 63 precludes national legislation providing that, where a resident company is subject to an obligation to withhold tax at source on the interest which it pays to a nonresident company, account is not taken of the expenditure in the form of interest, directly related to the lending at issue, which the latter company has incurred whereas, under that national legislation, such expenditure may be deducted by a resident company which receives interest from another resident company for the purpose of establishing its taxable income.

Implications

The final decisions of the CJEU largely support the arguments of the tax authorities, whereas the Opinion of the Advocate General published on 1 March 2018 was in favor of the taxpayers.

In dividend cases, taxpayers will be required to show that payment of dividends to intermediary companies was not part of a fraudulent or abusive arrangement. The test of abuse resembles the test to be carried out under the General Anti-Avoidance Rule set forth by the EU Anti-Tax Avoidance Directive (2016/1164) that must be implemented in national laws of the Member States by 1 December 2019. If the beneficial owner of a dividend is a tax resident in a third country with which Denmark has concluded a tax treaty, this fact may potentially mean that there is no abusive situation.

In interest cases, taxpayers must also show that there is no fraudulent or abusive arrangement. In addition, taxpayers must show that the recipient of the interest income is the beneficial owner thereof taking into account the OECD's interpretation of this concept.

The Danish courts that have referred these questions to the CJEU must now finally decide the cases based on the interpretation and guidelines provided by the CJEU. No matter how the cases will be decided by the Danish courts it is expected that appeals will be filed with the Danish Supreme Court. Thus, it may take some additional years before the cases are finally resolved.

Endnote

1. See cases C-115/16, C-116/16, C-117/16, C-118/16, C-119/16 and C-299/16.

For additional information with respect to this Alert, please contact the following:

Ernst & Young P/S, Copenhagen

- Jens Wittendorff jens.wittendorff@dk.ey.com

Ernst & Young P/S, Aarhus

- Søren Næsborg Jensen soeren.n.jensen@dk.ey.com

Ernst & Young LLP, Nordic Tax Desk, New York

- Antoine Van Horen antoine.vanhoren@ey.com
- Henry Cowan henry.cowan@ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

EYG no. 000670-19Gbl

1508-1600216 NY
ED None

ey.com