

The Danish Conduit Cases

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Two recent decisions of the ECJ

Skatteministeriet v T Danmark (C-116/16) and Y Denmark Aps (C-117/16)

concerned the Parent Subsidiary Directive (PSD) 90/435/EEC

N Luxembourg 1 (C-115/16) X Denmark A/S (C-119/16) C Danmark I (C-119/16) and Z Denmark ApS (C-229/16) v Skatteministeriet

concerned the Interest and Royalties Directive (IRD) 2003/49/EC

In both cases, the Court disagreed on almost every point with the opinion of the Advocate General. To be fair, the AG's view is what most commentators would have predicted but that was upended by the decision of the Court

Outline facts

Danish company paid a dividend or interest to a parent or other recipient established in another member state (being either Luxembourg, Cyprus or Sweden)

Under Danish law withholding tax (WHT) was due unless the exemptions provided for in the EU Directives were engaged

Ultimate shareholders were private equity or other entity established outside the EU and so not entitled to rely on the terms of the EU Directives

If the Danish company had paid the dividend direct to the ultimate shareholders WHT would have been due (subject to terms of any DT)

The PSD Directive

The PSD Directive applies to distributions of profits by companies of EU State A to parent companies in EU State B

Profits which a subsidiary distributes to its parent company are exempt from WHT

DTCs

The material DTCs between Denmark and the parent company jurisdiction or, where they existed, between Denmark and the ultimate shareholders' jurisdictions provided for Denmark to have a right to impose a WHT at a rate higher than that provided for in the DTCs, if the recipient was not the beneficial owner of the dividends

Example structure

Ultimate shareholder Private Equity in US

holding shares in

Luxembourg Company

holding more
than 50% of

Danish subsidiary

Proposed payment

Danish Sub

intends to pay DKK 6 billion

to Luxembourg Parent

which then might or might not pass onto its parent and ultimately to
the US investors

The issue

- Was the Danish Sub required to withhold tax on the dividend?
- Prima facie no as the PSD Directive applied as there was a dividend by an EU resident Sub to an EU resident parent and so the PSD exemption applied prohibiting any WHT on the dividends paid by the Sub
- Could the exemption be refused on the grounds that the structure involved a fraudulent or abusive practice?

Did a general anti-abuse rule apply?

It was common ground that Danish law had a case-law 'reality' principle which was not engaged on the facts.

The question arose whether there was an overarching abuse principle of EU law to which the answer was Yes

'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 or courts are to refuse a taxpayer the exemption from withholding tax on profits distributed by a subsidiary to its parent even if there are no domestic or agreement based provisions providing for such a refusal'

So what is abuse?

Objective circumstances in which, despite formal observance of the conditions laid down by EU rules, the purpose of those rules has not been achieved

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 or commercial justification, with the essential aim of benefiting from an improper advantage'

How do I spot it?

Group of companies an artificial arrangement where not set up for reasons that reflect economic reality, it is one of form and ***its principal or one of its principal objectives*** is to obtain a tax advantage running ***counter to the aim or purpose*** of the applicable tax law

Use of conduit company leads to avoidance of tax on the dividends

Dividends are passed on quickly by the conduit to entities that would not benefit from the PSD because they are not EU residents or not parent companies

Company receiving is purely a conduit company with little substance

Contractual arrangements / intra group loans/ complex financial transactions

Structure created in response to legislative change to avoid the new legislation

What if ultimate recipient is in country with DTC with source state such that no WHT payable

Surprisingly, this makes little or no difference [108]-[111]

'The existence of such a convention cannot in itself rule out an abuse of rightsif the company owing the dividends wishes to benefit from the advantages of such a convention, it is open to it to pay the dividends directly to the entities that are resident for tax purposes in a State which has concluded a double taxation convention with the source State'

'That said, 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'

'Where the beneficial owner of dividends is resident for tax purposes in a third State, refusal of the exemption.... is not in any way subject to fraud or an abuse of rights being found'

It is worth noting that the concept of beneficial owner does not appear in the PSD (although it does in the IRD and in the OECD and its commentaries)

How does this in to the underlying purpose?

Purpose of the PSD is to avoid double taxation of profits distributed by subsidiary to parent

The PSD is not intended to apply where the beneficial owner of the dividends is a company not resident in the EU where exemption from WHT might lead to no taxation in the EU

Who has to prove abuse?

Whilst alleged conduit company must furnish evidence to enable the tax authority to make a decision, it is for the member state to establish an abusive practice

However, the Member state does not have to establish who are the beneficial owners, just that it is not the conduit company

Can you rely on fundamental freedoms?
eg free movement of capital?

If there is fraud or abuse, you cannot rely on the Treaty freedoms.

The IRD 2003/49

'Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member state of a company of a Member State'

The IRD does use the concept of 'beneficial owner' which it defines as the receipt of payments for *'its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory for some other person'* – the Court took this as meaning the entity which benefits economically from the interest received and has the power to freely determine the use to which it is put and it was proper to have regard to the OECD materials on the meaning of beneficial owner.

DTCs

Having reviewed the relevant DTCs, the ECJ concluded that the Source State may tax interest paid to a person resident in another Member State if that person is not the beneficial owner

Danish law

The 'reality' principle of Danish law was not capable of preventing the availability of the exemption in these cases

'Beneficial owner'

Owner must benefit economically from the interest that is paid to it and must have dispositive power over the same

It was proper to have regard to the meaning of the term in the OECD Model Tax Convention

The absence of domestic or treaty anti-abuse provisions does not affect the general EU abuse rule

'.. 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'

Indicia of abuse

Largely the same as for the PRD

Conduit company lacks substance where sole activity is to act as a conduit whether that is a legal requirement or that is in substance its role

Terms of DTCs between source state and ultimate owners is irrelevant

SICAR

Societe d'investissement en capital a risque

'Is a company resident in Luxembourg, established and registered under Luxembourg company law as a 'societe en commandite par actions ' (SCA) and also classified as a 'Societe d'investisement en capital a risqué' ('SICAR') covered by the Directive 2003/49? [the IRD Directive]

SICARS were developed by Luxembourg for the PE industry.

ECJ said No – apart from absence of abuse, 3 requirements for a company to be entitled to benefit from the directive: the company must take one of the forms authorised by Directive (Yes - a SICAR does); be resident in Luxembourg (Yes – a SICAR is resident in Luxembourg); it must be subject to one of taxes listed in the Directive without being exempt, - whilst the SICAR was subject to one of the taxes listed, if the interest was exempt from the corporate income tax in Luxembourg, it failed the third test (No).

Free movement of capital Art 63

If there is fraud or abuse, then no reliance can be placed on the fundamental freedoms

If there is no fraud or abuse, then national legislation is precluded which levies WHT where the result is a difference in treatment between the payment of interest from a resident company to another resident company and a payment of interest from a resident company to a non-resident company where this results in a cash flow advantage to the resident company paying to another resident company – the levy of a WHT was justified in the public interest in cross-border cases, but the fact that a Danish resident recipient of interest was not required to pay corporation tax on the interest received for some two years was not.

Where a company obliged to impose WHT on payments to non-resident is obliged to pay a higher rate of default interest compared to a resident company which receives interest from another resident company, this is precluded by Art 63

Implications of Conduit cases – good for those looking for PhD topics

- If a MS rely on the general anti-abuse principle to deny benefits to taxpayers where the Directive has not been implemented in domestic law, how does this fit in the general theory of how directives operate – not thought to impose burdens on citizens if not implemented?
- Is there State Aid if a MS fails to apply the anti-abuse principle or does so in a business friendly manner?
- How much substance is required for intermediary holdings? How do you prove the intermediary is the beneficial owner?
- What are the contours and limits of this anti-abuse approach given it now applies to areas where there is minimal harmonisation such as direct tax?
- Is this a sword in the hands of tax authorities to be wielded at will and even selectively?
- How does one advise clients about existing structures?
- How will HMRC respond in the UK?

Context

This development has to be seen within the context of wider developments both within the EU, internationally, within member states and within the UK.

No doubt that these decisions represent a sea change in the attitude of ECJ towards tax avoidance. The Cadbury-Schweppes case referred to wholly artificial arrangements. In the past it was very difficult for States to avail themselves of defences to breaches of fundamental rights based on **fiscal cohesion** (as the UK attempted in the ACT litigation, Metallgesellschaft), and they rarely succeeded, but this has now changed.

BEPS 6

BEPS 6 addressed Treaty Shopping

BEPS 6 to introduction of Principal Purpose Test into new DTCs and to adoption of the MLI (in the UK see The Double Taxation Relief (Base Erosion and Profit Shifting) Order 2018)

Article 7 – Prevention of Treaty Abuse

Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.

DTC clause

For example, Article 23 of the 2018 UK-Cyprus Convention

‘Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or a capital gain if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.’

EU Anti-Tax Avoidance Directive GAAR

Article 6

General anti-abuse rule

- 1. For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.*
- 2. For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.*
- 3. Where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law.*

UK

- Even where a transaction has a commercial objective, a main purpose may still be tax avoidance or obtaining a tax advantage *‘even if each of the transactions was entered into for a genuine commercial purpose, it may still be the case that a main object of structuring them in the way they were was to obtain the capital allowances’* Lloyds TSB Equipment Leasing (N01) Limited v Revenue and Customs Commissioners [2014] STC 2770
- The rise and rise of ‘purposive construction’ (applying the provisions interpreted purposively to the facts viewed realistically) in cases of tax avoidance and the influence of the GAAR, see *UBS* [2016] 934