Tax Flash
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Landmark ECJ decisions on beneficial ownership. A failed revolution?

Executive summary

On February 26, 2019 the Grand Chamber of the European Court of Justice ("**ECJ**") issued two groundbreaking decisions on six joined "Danish cases" mainly relating to (i) the notion of beneficial ownership under EU law and (ii) abuse of both the Interest and Royalties Directive ("**IRD**") and the Parent Subsidiary Directive ("**PSD**" and, together with the IRD, the "**Directives**"). A revolutionary ruling was hoped to being issued in favor of taxpayers, following the Advocate General Kokott's opinion[1]. Conversely, the ECJ widely supported the arguments that are usually raised by tax authorities. The ECJ decisions may impact on the cross border investment structures of private equity operators and multinational groups.

Facts

The first decision was concerning four cases of denial of the IRD's withholding tax exemption at source on outbound interest payments made by Danish companies ("**Interest cases**"). Out of them, three cases[2] dealt with outbound interest paid by the Danish subsidiaries to the EU sub-holding company, ultimately held (via an intermediary holding company located in Luxembourg) by non EU-based private equity funds. The further Interest case[3] involved a US multinational group where the Danish subsidiary borrowed from the Swedish upper-tier company, the latter had indirectly received loans from a Cayman company.

The second decision dealt with the denial of the PSD's withholding tax exemption at source ("**Dividend cases**"). Namely, a first case[4] was regarding outbound dividend paid by a Danish company to the Luxembourg-based parent company, ultimately held by non EU-based private equity funds. The second case[5] dealt with a US multinational group where the Danish subsidiary paid dividend to the Cyprus parent company which, then,

[1] Delivered on 1 March 2018.
[2] C-115/16 "N Luxembourg I", C-118/16 "X Denmark" and C-299/16 "Z Denmark".
[3] C-119/16 "C Denmark I".
[4] C-116/16 "T Denmark".
[5] C-117/16 "Y Denmark".

used the proceeds to repay interest and principal to its Bermuda parent company, the latter finally repatriating profits to the US ultimate shareholder.

The ECJ decisions touched upon multiple “hot topics” for international corporate tax structuring.

The beneficial ownership

The ECJ upheld that a company of a EU member State is to be treated as the beneficial owner of interest or dividend payments whether (i) in terms of economic reality, it receives those payments for its own benefit and not as an intermediary; (ii) in terms of economic benefit, it is the entity which economically benefits from the interest/dividend payments and has the power freely to determine the use to which they are put (*i.e.* it may freely dispose of the income received). In the Interest cases the ECJ further clarified that the beneficial ownership requirement is to be interpreted in light of the notion included in OECD bilateral conventions and the relating commentaries as well.

In a nutshell, the ECJ followed a “substance over form” approach by emphasizing the unconstrained right of the payee to economically benefit from the sums received rather than looking at the legal form. As such, the Italian tax authorities’ approach seems to be supported whereby a complex (and strict) notion of beneficial ownership has been given in light of both (i) the availability of income to the recipient, and (ii) the “substance” of the recipient.

Surprisingly, ECJ ruled that the exemption under the PSD must be refused if the beneficial owner is deemed to be actually a non EU-based company even though beneficial ownership is not a law requirement under the PSD. In so doing, the ECJ seemed to forget its recent and more favorable case law line preventing national measures aiming at denying the PSD in cases of holding companies held by non EU-based entities (e.g. “Deister Holding”[6] and “Juhler Holding”[7] cases).

The EU general principle of abuse

ECJ invoked a general principle of EU law preventing abusive practice that must be relied upon by national tax authorities and tax courts to refuse a taxpayer the withholding tax exemption under both Directives, regardless of whether there are domestic or agreement-based provisions providing for such a refusal. A case-by-case assessment of facts is needed to establish whether the interposed EU (artificial) companies have not been set up for doing a real economic activity but to obtain (as essential aim) a tax

[6] C-504/16.
[7] C-613/16.

advantage that run afoul of the purpose of the Directives. Burden of proof is on the tax authorities but the latters are not required to further identify who the beneficial owners are actually deemed to be.

Indicia of abuse

Even though it is for the national tax courts to assess the elements of abuse, the ECJ issued guidance in that respect by highlighting a number of indicia of artificial arrangements:

- that all or almost all of the interest/dividend income is, very soon after its receipt, passed on by the payee to entities that would not be entitled to the Directives ("back to back" situations deriving from both financial arrangements or not);
- the payee company only makes an insignificant taxable profit so acting as conduit entity to enable a flow of funds from the payer to the actual beneficial owner (that would have not been entitled to the Directives should a direct payment have taken place);
- the interposed companies' sole activity is to act as pass-through entities of interest/dividend income, as may be inferred from the management of the company, the balance sheet, the structure of its costs and expenses, the number of employees and their skills, the relevant premises and equipment, the contractual provisions allowing the intragroup flow of funds to the ultimate shareholders free of any (or with a minimum) tax burden.

Surprisingly, the ECJ further argued that, with regard to the assessment of abuse, it is immaterial that the beneficial owners of the pass-through income are tax resident in a third State with which a Convention to avoid double taxation ("**DTC**") is in place granting a withholding tax exemption at source. It is worth remembering that the Italian tax authority more than once (e.g. in circular 30 March 2016, No. 6) recognized, as fallback scenario, that the DTC with the State of the ultimate investors may be applicable under a look-through approach.

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