EU Court decides on abuse in Danish interest tax cases

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Introduction

On February 26, 2019, the Court of Justice of the European Union (CJEU) decided on four cases (C-115/16, C-118/16, C-119/16 and C-299/16) referred by the Danish Courts regarding the grant or denial of an interest withholding tax exemption as provided for by the EU Interest & Royalty Directive (I/R Directive). (See our alert regarding the dividend withholding tax exemption cases C-116/16 and C-117/16 here).

Facts

In case C-115/16, five investment funds incorporated Luxembourg and Danish companies to acquire a target company in Denmark. None of the investment funds were established in a Member State of the European Union or in a country that had concluded a tax treaty with Denmark. In the period 2006-2008, the Danish company paid significant amounts of interest to Luxembourg company, and the Luxembourg company had similar debt and interest obligations towards the five investment funds.

In case C-118/16, a number of investment funds incorporated a Luxembourg venture capital vehicle and a Swedish two-tier structure to acquire a target company in Denmark. In 2006, the Luxembourg company granted a loan to its Swedish subsidiary of approx. €500mio and the other Swedish company subsequently granted a loan to almost the same amount to its Danish subsidiary. The Danish company paid significant amounts of interest to its Swedish parent company and the other Swedish company paid significant amounts of interest to its Luxembourg parent company. The interest was not taxed in Luxembourg (due to the SICAR-regime).

In case C-119/16, a US multinational owned a Cayman Island company, that in turn owned a Danish company. The Cayman company incorporated a Swedish two-tier structure and another Danish company to own the Danish group company. The Cayman company provided loans of approx. €900mio to the Swedish company and the Swedish subsidiary company granted similar loan amounts to the Danish company. The Danish company paid significant amounts of interest to the Swedish parent company and the other Swedish company paid similar amounts of interest to its Cayman parent company.

In case C-299/16, five Jersey investment funds incorporated a Luxembourg company to acquire a Danish company. The Jersey funds provided loans to the Luxembourg company, and the Luxembourg company provided similar loans to the Danish company. The Danish company paid significant amounts of interest to the Luxembourg parent company.

Based on the I/R Directive, the Danish companies wanted to pay interest to their respective parent companies in Luxembourg and Cyprus free of Danish interest withholding tax. The Danish tax authorities challenged these claims.

The I/R Directive refers to the concept of beneficial owner: a company shall be treated as the beneficial owner of interest only if it receives those payments for its own benefit and not as an intermediary, such as an agent, trustee or authorized signatory, for some other person. The I/R Directive allows an EU Member State to implement anti-abuse measures in its national law (or in a bilateral tax treaty), but there is no obligation to do so. In the relevant years, the Danish tax code did neither refer to the concept of beneficial owner nor contain anti-abuse rules with respect to the I/R Directive.

How must the concept of beneficial ownership be interpreted?

The Danish Courts wanted to know how the concept of beneficial owner of interest as mentioned in the I/R Directive needs to be interpreted. Must each EU Member State give its own meaning to it or can one for example rely on the commentaries to the OECD Model Tax Convention? The CJEU decided that it cannot be accepted that each EU Member State gives its own interpretation to this concept, and that it must be interpreted in line with the OECD commentaries. It further clarifies that if the recipient of the interest is not the beneficial owner, this does not automatically mean that the exemption does not apply. The exemption may still apply if the identified beneficial owner meets all conditions as mentioned in the I/R Directive.

Are domestic anti-abuse rules required to combat abuse?

The Danish Courts wanted to know whether Denmark had to deny the interest withholding tax exemption, even though it did not implement anti-abuse rules as referred to in the I/R Directive in its domestic law. The CJEU decided that an EU Member State must deny the interest withholding tax exemption if the exemption is not claimed to achieve the objectives of the EU I/R Directive, but to obtain this benefit by solely meeting the formal conditions. The CJEU recalls that a taxpayer has the right to choose the most beneficial tax alternative, but not if this is realized through a purely artificial structure that does not reflect economic reality, and is aimed to avoid the laws of an EU Member State.

The CJEU answers that an EU Member State is not required to implement anti-abuse rules in domestic law to combat abuse of EU law. An EU Member State is obliged to deny tax benefits stemming from EU law in case of abuse of EU law, whether anti-abuse rules are implemented in its domestic law or not.

What are indicators of abuse of EU law?

In order to demonstrate that there is abuse of law, it requires (i) a combination of objective circumstances in which, despite formal observance of the conditions laid down by the EU rules, the purpose of those rules has not been achieved and (ii) a subjective element consisting of the intention to obtain an advantage from the EU rules by artificially creating the conditions laid down for obtaining it. Therefore, all relevant facts of the cases need to be assessed and judged on by the Danish Courts. The CJEU provides the Danish Courts with guidance and states that a certain number of the following indicators may demonstrate there is an abuse of law, as long as these indicators result in a consistent conclusion:

a. A group that is not established for reasons that reflect the economic reality, is purely formal and is mainly meant to obtain a tax advantage that is not in line with the object of the applicable law, can be regarded as an artificial structure. For example, if a conduit company is interposed to obtain a tax benefit and that company receives interest and pays that (to a large extent) shortly thereafter to its lender, who is not entitled to the same tax benefit, this forms an indicator of abuse of law.

b. The receipt of interest is the sole activity of the conduit company, and the conduit company does not perform any economic activities. Whether the latter is the case needs to be assessed based on how the company is managed, its balance sheet, its costs structure, its expenses, its staff and its premises and equipment.
c. An artificial arrangement may also be constituted by thinly capitalized structures through intra group debt and interest payments, resulting in the conduit company's inability to have economic use of the interest. This does not only have to be the case if there is a contractual or legal obligation to pass on the interest. Also if 'in substance' the conduit company does not have the right to use and enjoy the interest. For the interpretation of the concept of beneficial ownership, the CJEU refers to the OECD commentaries.
d. The introduction of new tax legislation (such as in Denmark or the USA) and the interposition of a conduit company around the time of introduction may also be an indicator of abuse of law.

Who has the burden of proof?

The company that claims the withholding tax exemption must demonstrate that the parent company meets the formal conditions for the exemption. If the tax authorities want to refuse the exemption based on an abuse of law, then the tax authorities have the burden of proof to demonstrate this. In case of a conduit company, the tax authorities do however not have any duty to demonstrate who the actual beneficial owner of the interest is. It seems that if the company is of the view that without the interposition of a conduit company, the interest withholding tax would have been less than re-assessed, that company must demonstrate who the actual beneficial owner is and what the interest tax burden would have been.

What does subject to income tax mean?

The I/R Directive requires that the recipient of the interest is subject to corporate income tax, without being exempt or having an option of being exempt. The Luxembourg SICAR in C-118/16 is subject to Luxembourg corporate income tax, but not in relation to the interest income received because of the SICAR-regime. In such case, based on the objective of the I/R Directive, the subject to tax condition is not fulfilled according to the CJEU.

Application of the EU freedoms

In case there is no abuse of law, the Danish Court wants to know whether Denmark can exercise all its withholding tax rights. First, the CJEU recalls that in the case of payments of interest due on loans between companies established in two different EU Member States, the questions of the Danish Courts must be examined in the light of the freedom of capital. Secondly, the CJEU determines that the fact that withholding tax is only levied in cross border situations forms a restriction of the freedom of capital. Such a restriction may however be justified to efficiently collect the taxes. However, if the Danish withholding tax needs to be paid upon payment of interest in a cross border situation immediately, and in case of a domestic situation only after two year, this forms a restriction of the freedom of capital that cannot be justified. Thirdly, Denmark charges a higher interest in case of late payment of withholding tax in cross border situation than in case of domestic situations. This forms a restriction of the freedom of capital which cannot be justified either. Finally, Denmark levies the withholding tax on the gross interest payments in case of a cross border situation, but takes into account the corresponding interest expenses in a domestic situation. The CJEU decides that this forms a restriction of the freedom of capital that cannot be justified if the non-resident recipient has incurred interest expenses to grant the loan to the Danish company.

Relevance for the Dutch tax practice

Arm's length interest paid by a Dutch company is not subject to withholding tax. If a non-resident company directly or indirectly owns at least 5% of the nominal paid-up share capital of a Dutch company and receives interest income from that Dutch company, the interest is not subject to Dutch corporate income tax, unless the main reason or one of the main reasons to interpose such company was to avoid Dutch personal income tax that otherwise would have been due and in addition thereto the interest recipient was not established for valid commercial reasons that reflect economic reality. In case of an interposed parent company that creates a link between the activities of its parent company and the Dutch company, Dutch law provides for a safe harbor to assess whether the interposed parent company is established for valid commercial reasons that reflect economic reality (see below). Having regard to the above EU cases, if an interposed parent company's sole or main activity is the holding of shares in the Dutch company and the grant of a loan to that Dutch company, special care must be given to the main reasons to interpose that parent company as well as to its level of economic substance. With respect to the latter, the safe harbor rule could function as guidance.

Substance requirements for a non-resident holding company

1. At least 50% of the total statutory and executive members of the board of directors live or are established in the state in which the holding company is a resident ('resident directors');
2. The resident directors of the holding company have the necessary professional knowledge to perform their duties well. These duties consist of at least the decision taking on basis of the holding company's own responsibility and within the framework of the usual involvement of the holding company's headquarter with respect to transactions to be concluded by the holding company as well as the proper dealing of the concluded transactions;
3. The holding company has qualified personnel for the adequate execution and registration of the holding company's transactions;
4. The board decisions are taken in the state in which the holding company is a resident;
5. The main bank accounts of the holding company are kept in the state in which the holding company is a resident;
6. The bookkeeping of the holding company takes place in the state in which the holding company is a resident;
7. The wage costs that form a remuneration for linking the activities within the shareholder chain amount to, translated to Dutch standards, at least €100,000; and
8. The holding company owns or rents office space in the state in which the holding company is a resident for a period of at least 24 months, and which office is equipped to perform the linking role referred to under 7, which role is actually performed from that office.

Your Key Contacts

Heico Reinoud
Partner, Amsterdam
D +31 20 795 34 14
heico.reinoud@dentons.com

Roland Meuwissen
Associate, Amsterdam
D +31 20 795 30 07
M +31 6 15 88 09 28
roland.meuwissen@dentons.com