

# CJEU judgments affecting conduit companies

## Summary

In two recent judgments, the Court of Justice of the European Union has clarified that EU Member States are obliged to deny conduit companies the exemptions from withholding tax on dividends, interest and royalties under the EU Parent Subsidiary Directive and the EU Interest & Royalties Directive. The basis of this obligation is the general legal principle that EU law, including said directives, cannot be relied on for abusive or fraudulent ends. The principle applies regardless of whether a Member State has implemented relevant anti-abuse provisions and, if so, whether they are adequate.

In the two judgments, the Court proposes numerous indications that a company is a conduit company and it makes clear that tax authorities need not identify the beneficial owner of the dividend, interest or royalties in respect of which the recipient entity claims a withholding tax exemption under the directives; they merely have to demonstrate that the beneficial owner is not the recipient – or not resident in a Member State.

The judgments will have consequences for Dutch companies receiving dividends, interest or royalties from entities in other Member States, if such companies are considered conduit companies by those other Member States. The judgments may also have consequences for Dutch companies paying dividends to companies in other Member States, if the latter are conduit companies by the Court's standards; such companies might turn out to not be able to rely on advance tax rulings and safe harbours for the exemption from withholding tax of outbound dividends. Dutch companies paying interest or royalties to companies in other Member States are not affected by the judgments, because there is no withholding tax on such payments in the Netherlands, though that is likely to change in 2021. Ultimately, the Court's judgments could affect the applicability of the well-known participation exemption, in the sense that Netherlands-resident companies presently enjoying that concession with respect to qualifying participations in subsidiaries resident in Member States, can not do so in the case that, by the Court's standards, they do not qualify as the beneficial owner of inbound dividends.

Clients are advised to have their particular situation examined with a view to establishing whether it is or will be affected by the CJEU's judgments and whether, if that may be the case, there are acceptable and viable remedies to mitigate the consequences.

## Introduction

On 26<sup>th</sup> February, the Court of Justice of the European Union (**CJEU**) passed two judgments in a number of joined cases regarding conduit companies that sought to benefit from exemptions from Danish withholding tax on dividends and interest under the EU Parent Subsidiary Directive (**PSD**) and the EU Interest & Royalties Directive (**IRD**).

It took some time for these judgments to be made public and for the dust to settle. Their importance is that they clarify the circumstances in which companies may be classified as conduit companies and that Member States must deny conduit companies the exemption from withholding tax of dividends under the PSD and of interest and royalties under the IRD, regardless of whether the Member State in question has enacted adequate anti-abuse provisions. The judgments are likely to have an impact on the exemption from dividend tax in the Netherlands, on advance tax rulings issued by the Dutch tax authority and on the bill introducing a withholding tax on interest and royalties which is expected to enter into force in the Netherlands in 2021, as is explained in this article.

## PSD cases

The CJEU's judgment in the cases concerning the application of the PSD addressed the question whether the combating of fraud or abuse, as permitted by the PSD, requires the Member State in question to have enacted a domestic or agreement-based anti-abuse provision as referred to in the Directive. The CJEU has made it clear that there is a general legal principle that EU law, including the PSD, cannot be relied on for abusive or fraudulent ends. Member States are obliged to enforce this general legal principle regardless of whether they have enacted anti-abuse provisions and if so, regardless of whether such provisions are adequate.

## *Abuse of the PSD*

The CJEU then proceeds to describe the constituent elements of an abuse of EU law. Central to the definition of an abuse of EU law is the presence of an artificial arrangement which is not set up for reasons that reflect economic reality, of which the structure is purely one of form and its principle objective or one of its principle objectives is to obtain a tax advantage running counter to the aim or purpose of the applicable tax law. In the case of the PSD, such arrangement presents itself in the event that a conduit company is interposed in a structure of a group between the company that pays a dividend and the company in the group which is the beneficial owner of that dividend and this results in the avoidance of the payment of tax on that dividend.

## *Conduit company*

The CJEU goes on to extensively describe situations that can be classified as artificial arrangements in relation to the PSD. Those situations have in common that the company claiming the exemption from withholding tax on dividends can be characterised as a conduit company. An indication that a company functions as a conduit company is that the company passes on all or almost all of the dividends, very soon after their receipt, to entities that do not meet the conditions for the application of the PSD. Entities might not meet those conditions on the basis that they are not established in any Member State, that they are not incorporated in one of the forms covered by the PSD,

# CJEU judgments affecting conduit companies

because they are not subject to one of the taxes listed in the PSD or for various other reasons. Another such indication is that the company receiving the dividend must itself pass that dividend on to a third company which does not fulfil the conditions of the PSD and that it realises only an insignificant taxable profit in doing so.

A conduit company is characterised by its sole activity being the receipt of dividends and their transmission to the beneficial owner or to other conduits and the absence of actual economic activity. Such absence of economic activity must, according to the CJEU, be inferred from factors such as the management, the balance sheet, the structure of the costs, the expenditure actually incurred, the staff employed by the company and the premises and equipment that it has. An important indication that a company acts as a conduit company is, according to the court, that it is unable to have economic use of the dividends received. That inability can not only be based on a contractual or legal obligation of the company receiving the dividends to pass them on to a third party, but also by the fact that, 'in substance', that company, without being bound by such contractual or legal obligation, does not have the right to use and enjoy those dividends.

The indication that a company acts as a conduit company can be reinforced by the simultaneity or closeness in time of, on the one hand, the entry into force of major new tax legislation and, on the other hand, the setting up of complex financial transactions and the granting of intragroup loans.

The CJEU has clarified that there can also be an abuse of EU law in the case that the beneficial owner of the dividend transferred by the conduit company is a company resident in a third state with which the state from which the dividend originates has concluded a tax treaty, under which no tax would have been withheld on the dividend if it had been paid directly to that beneficial owner. In the case that it considers that the recipient of the dividend should be denied the exemption under the PSD, the tax authority of the Member State from which the dividend originates, is not tasked with identifying the beneficial owner of such dividend, but with establishing that the company claiming the exemption is merely a conduit company through which an abuse of rights has been committed.

## **IRD cases**

One of the conditions for the applicability of the IRD is that a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State qualifies as beneficial owner of the interest or royalties. Prompted thereto by the referring Danish courts, the CJEU explains extensively how the expression 'beneficial owner' must be interpreted.

## *Beneficial owner*

According to the CJEU, the beneficial owner of the interest or the royalties is the entity which actually benefits from the interest that is or the royalties that are paid to it. An intermediary, such as an agent, a trustee or authorised signatory receiving the interest or the royalties for the benefit of some other person, is not to be treated as beneficial owner and only an entity established in the EU can be a beneficial owner within the meaning of the IRD. The expression 'beneficial owner' is also used in bilateral tax treaties based on the OECD Model Tax Convention and the commentaries on that model are relevant to the interpretation of the expression 'beneficial owner' in the IRD. The development of the OECD Model Tax Convention and the commentaries on that model make clear that conduit companies cannot qualify as beneficial owners. The fact, however, that interest or royalties are received by a conduit company does not imply that the exemption under the IRD must be denied; that exemption can be granted in the event that the recipient of the interest or royalties transfers it or them to a beneficial owner who satisfies the conditions of the IRD.

## *Abuse of the IRD*

As in its judgment in the PSD cases, the CJEU makes it clear that there is a general legal principle that EU law, including the IRD, cannot be relied on for abusive or fraudulent ends and that Member States are obliged to enforce this general legal principle regardless of whether they have enacted anti-abuse provisions and if so, whether such provisions are adequate. The constituent elements of an abuse of EU law in the judgment regarding the IRD cases are virtually the same as in the PSD cases. By their nature, however, interest and royalties can have the effect of eroding the basis of assessment of the company paying them, so an indication of an abuse of the IRD is the presence of various contracts between the companies involved in the financial transactions at issue, giving rise to flows of funds which have the aim of transferring profits from a profit-making commercial company to shareholding entities in order to avoid or reduce as much as is possible the tax burden on those profits.

## *Luxembourg SICAR and subject-to-tax condition*

The applicability of the IRD is subject to the condition that the beneficial owner of the interest or royalties is effectively subject to tax on the interest or royalties in its Member State. One of the companies posing as beneficial owner in the IRD cases was a Luxembourg SCA (*société en commandite par actions*) authorised as a SICAR (*société d'investissement en capital à risqué*). Formally, a SICAR is subject to corporate tax in Luxembourg on its profits. SICARs benefit from a specific tax regime, however, pursuant to which income deriving from transferable securities, which can include interest, is exempt from Luxembourg corporate tax. The Danish court which referred the relevant IRD case to the CJEU contended that the SICAR in question was, in fact, exempt from

# CJEU judgments affecting conduit companies

Luxembourg corporate tax. In its judgment on the IRD cases, the CJEU rules that a SICAR is not eligible for the exemption from withholding tax under the IRD, if the interest received by that company is exempt from corporate tax in Luxembourg. The CJEU leaves it to the Danish court to determine whether that is the case.

## Significance of the CJEU judgments where companies in the Netherlands are concerned

### *Dividends – withholding tax*

The judgment in the cases concerning the application of the PSD regarded the original version (90/435/EEC). That version has, in the meantime, been replaced by Directive 2011/96/EU which, following Directive 2015/121/EU, contains a general anti-abuse provision, which Member States are required to transpose into their domestic laws. The Netherlands have done this by inserting a general anti-abuse rule into their Dividend Tax Act 1965. The wording of this general anti-abuse rule is largely in line with the abstract definition of an abuse of EU law. The legislator and the Ministry of Finance have, however, given extensive guidance on the scope of the general anti-abuse rule as laid down in the Dividend Tax Act 1965. It is clear that this guidance and the guidance the CJEU has given on the scope of the general legal principle that the PSD cannot be relied on for abusive or fraudulent ends are not the same and the former may be superseded in favour or to the detriment of corporate taxpayers, as the case may be, by the guidance given by the CJEU.

Furthermore, the Tax Authority has issued numerous advance tax rulings confirming that in concrete situations dividend tax need not be withheld. Although the Tax Authority's policy is to issue such rulings only in situations in which there is a legal basis for such confirmation, the legislator's and Ministry of Finance's guidelines that it must have used to determine whether there was a legal basis may turn out to clash with the guidance given by the CJEU in its judgment on the PSD cases. Considering that, according to the CJEU, the Tax Authority and, ultimately, the courts, have a duty to enforce the general legal principle that EU law, including the PSD, cannot be relied on for abusive or fraudulent ends, advance tax rulings on situations falling within the reach of the PSD as well as other domains that are affected by EU law may turn out not to offer the advance certainly that taxpayers sought by applying for them.

### *Dividends – participation exemption*

The participation exemption – the exemption on basis of which dividends and gains deriving from qualifying participations are exempt from corporate tax, is a domestic concession transposing the PSD. This calls into question whether the Dutch tax authority must also deny Dutch companies the participation exemption in cases in which they are conduits pursuant to the CJEU's

'definition'. The conditions to which the participation exemption is subject statutorily, do not exclusively concern themselves with the situation in which a Dutch holding company must be characterised as a conduit company, so if the aforementioned question had to be answered in the affirmative, there would be far-reaching consequences.

### *Interest and Royalties*

Presently, there is no withholding tax on interest and royalties paid by Dutch persons to resident and non-resident recipients. So, the answer to the question whether such interest or royalties are paid to a conduit company versus a beneficial owner in a Member State is, for the moment, not relevant, other than in rare situations. This may change in 2021 if, as is expected, Parliament passes a bill introducing a withholding tax on interest and royalties that are paid to persons resident in tax havens and in abusive situations. That bill is expected to enter into force at the beginning of 2021. The bill in question has not yet been submitted to Parliament, but it stands to reason that companies established in other Member States acting as conduits for interest or royalties paid to persons in tax havens will be affected if they can be classified as conduit companies by the criteria set forth by the CJEU.

### *Contact*

Should you require our assistance, please contact Maarten Jan Brouwer or Derk Prinsen.

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