European Union

Abuse of Law under EU Directives

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In this article, the authors discuss the so-called "Danish cases", *T Danmark* (Case C-116/16) and *Y Denmark* (Case C-117/16), in which the Danish tax authorities denied the benefits of the Parent-Subsidiary Directive under the EU abuse-of-law concept.

1. Introduction

The public debate on tax fraud and tax evasion has many participants today. The recent case law of the European Court of Justice (ECJ) in the so-called "Danish cases", *T Danmark* (Case C-116/16)[1] and *Y Denmark* (Case C-117/16), adds to this discussion. These cases play an important role in the possibility for tax authorities of Member States of the European Union and European Economic Area (EEA) to combat tax evasion through abusive structures.

The dispute in both cases is whether T Danmark and Y Denmark can enjoy the tax advantages provided for by the Parent-Subsidiary Directive (2011/96)[2] by distributing dividends to their EU parent companies without any Danish (withholding) taxation (i.e. a tax exemption at source). The Danish tax authorities argued in both cases that the respective structures concern abuse of law and that the exemption provided for in the Parent-Subsidiary Directive (2011/96) does not apply.

Many tax professionals have perceived the ruling as far reaching and possibly in conflict with other case law of the ECJ. In this article the authors argue that the ruling is not that controversial and fits within the existing legal framework previously set out by the ECJ. This is very relevant for (private equity) investors making use of a European holding company, special purpose vehicle or joint venture company with limited activities.

In sections 1.1. and 1.2. the Danish cases will be discussed. Subsequently the authors will discuss whether the ruling fits in the existing legal framework of the abuse of law concept. In section 3. the *Deister* holding case[3] will be discussed, and in section 4., the authors conclude that the abuse of law concept is still subject to strict interpretation. As such, the conclusion (in section 5.) of the article is that tax authorities can only deny the benefits of the Parent-Subsidiary Directive (2011/96) after having reviewed all relevant factors and if there is a clear abusive situation.

1.1. *T Danmark* and *Y Denmark*

When reading the ruling of the ECJ, one may wonder why one case is called "T Danmark", with an "a", and the other is called "Y Denmark", with an "e". Did the court make a mistake? Usually the ECJ does not make such mistakes. The reason for this is probably that the T Danmark concern is originally Danish, even though it is owned by foreign private equity investors. In Danish, Denmark is called "Danmark". The corporation that owns Y Denmark originated in the United States and obviously, in English, the country is called "Denmark". This also explains the group structure of both concerns.

T Danmark is acquired and owned by at least five private equity funds through an intermediary holding company (with low substance) based in Luxembourg. The private equity funds reside in countries that do not have tax treaties with Denmark.

Y Denmark is ultimately owned by a US entity and indirectly held via a company residing in Bermuda and directly held by a low-substance holding company in the European Union based in Cyprus.

The similarity between both cases is that a Danish company makes a dividend distribution to a low-substance holding company in the European Union that is owned by shareholder(s) in a country that does not have a tax treaty with Denmark. If the dividend was paid directly to the underlying shareholders, the exemption would not be applicable. The simplified structures are depicted in Figure 1.

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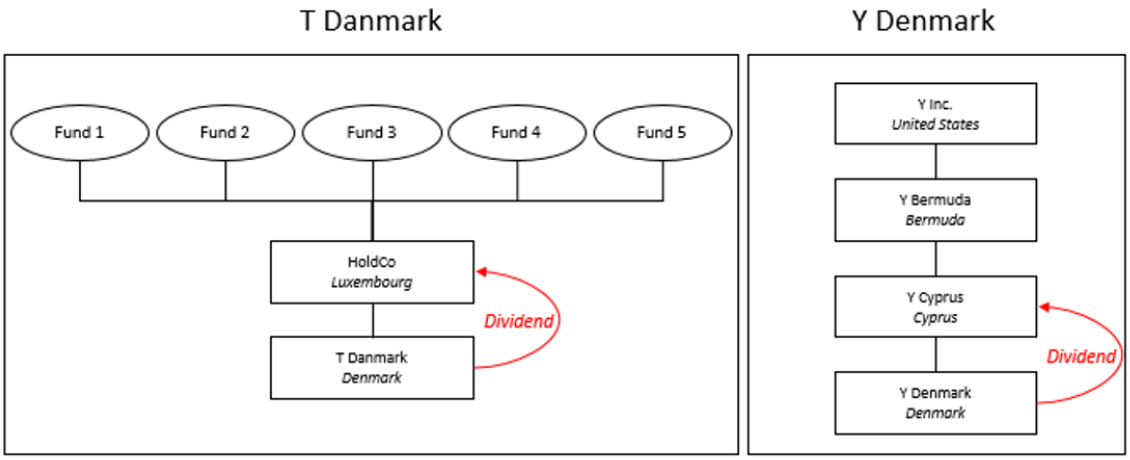
1. DK: ECJ, 26 Feb. 2019, Case C-116/16 , Joined cases C-116/16 and C-117/16, *Skatteministeriet v. T Danmark* , ECJ Case Law IBFD (accessed 10 Dec. 2019).
2. Council Directive 2011/96/EU of 30 November 2011 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, OJ C 107 (2011), p. 73 [hereinafter Parent-Subsidiary Directive (2011/96)].
3. DE: ECJ, 20 Dec. 2017, Case C-504/16 , *Deister Holding* , Case Law IBFD.

Figure 1



2. Danish Tax Inspector

In both cases, the Danish tax inspector denied the benefits of the Parent-Subsidiary Directive (2011/96) because in his opinion both structures concerned abuse of law. This position is based on article 1(2) of the Parent-Subsidiary Directive (2011/96), which states:

> This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse.

The Østre Landsret (High Court of Eastern Denmark) requested the ECJ for a preliminary ruling on no less than eight preliminary questions. In summary, the relevant questions for the abuse of law doctrine are the following:

(1) Is it required for a Member State that denies the benefits of the Parent-Subsidiary Directive (2011/96) based on domestic provisions of fraud or abuse to have adopted a specific domestic provision implementing the anti-abuse provision of the Parent-Subsidiary Directive (2011/96) or to have a general provision or principle on fraud and abuse that can be interpreted in accordance with the anti-abuse provision laid down in the Parent-Subsidiary Directive (2011/96)?

(2) Is a tax treaty and, more specifically, a beneficial owner clause in a tax treaty, an agreement-based anti-abuse provision covered by the anti-abuse provision in the Parent-Subsidiary Directive (2011/96)?

(3) What are the constituent elements of an abuse of rights and how may those elements be established under the Parent-Subsidiary Directive (2011/96)?

2.1. Is a specific anti-abuse provision required?

The Parent-Subsidiary Directive (2011/96) is a Council Directive that falls under secondary EU law. Such Council Directive contains provisions that must be implemented in domestic law before entering into force. “Old” case law of the ECJ states that if a Member State has not yet (correctly) implemented a directive, the provisions of the directive cannot be held against citizens of that Member State.[4]When implementing the provision of the Parent-Subsidiary Directive (2011/96), Denmark did not implement a specific anti-abuse rule to deny the benefits of the Parent-Subsidiary Directive (2011/96) in abusive situations.

The ECJ ruled repeatedly that there is a general legal principle that EU law cannot be relied upon for abusive or fraudulent ends, regardless the area of law. Based on this principle, Member States are to refuse the benefits of the provisions of EU law in abusive situations. This principle is already known under the primary EU law, i.e. under the fundamental freedoms,[5]but also in customs case law[6]and under the VAT Directive.[7]The Parent-Subsidiary Directive (2011/96) states that the directive is not to preclude application of the domestic or agreement-based provisions required for the prevention of fraud or abuse. However, according to the ECJ, this cannot be interpreted as excluding the application of the general principle of EU law.

4. IT: ECJ, 12 Dec. 1996, Case C-74/95 , Joined Cases C-74/95 and C-129/95, *Criminal proceedings against X* , Case Law IBFD.
5. DK: ECJ, 5 July 2007, Case C-321/05 , *Hans Markus Kofoed v. Skatteministeriet* , Case Law IBFD; BE: ECJ, 11 July 2018, Case C-356/15, *Commission v. Belgium* .
6. Consideration 73.
7. Consideration 76.

This means that Member States are to refuse the benefits of the Parent-Subsidiary Directive (2011/96) based on the general EU principle of abuse and fraud. A domestic anti-abuse provision is not required according to the ECJ.

2.2. Is a double tax treaty and, more specifically, a beneficial owner clause in a tax treaty, an agreement-based anti-abuse provision covered by the anti-abuse provision in the Parent-Subsidiary Directive (2011/96)?

Since this general principle can be accepted to deny the benefits of the Parent-Subsidiary Directive (2011/96), the ECJ felt no need to go into the status of tax treaties as requested by the Danish High Court.

The third question becomes even more relevant, since the EU anti-abuse principle is apparently an independent doctrine.

2.3. What is the EU definition of abuse of rights under the Parent-Subsidiary Directive (2011/96)?

It is clear from the Court's prior case law that an abusive practice is in place if the structure (i) is a wholly artificial arrangement that does not reflect economic reality (the objective test); or (ii) is only in place with the aim of escaping the tax normally due (the subjective test).[8]Even though it is not up to the ECJ to assess facts in a proceeding, the Court decided to specify indicators to guide the national court(s) to assess whether abuse can be established under the Parent-Subsidiary Directive (2011/96).

The challenge for the ECJ in the Danish cases was to further define the abuse of law concept it had previously established, but now more specifically and under the interpretation of the Parent-Subsidiary Directive (2011/96).

The ECJ has repeated its ruling 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". In the context of the Parent-Subsidiary Directive (2011/96) this is the case if:

– a *conduit entity* is interposed in the structure of the group between the company that pays dividends and the company in the group that is their beneficial owner; and

– payment of tax on the dividends is avoided.

2.3.1. Interposing a conduit entity

While explaining the anti-abuse doctrine, the ECJ chose to define the concept of "conduit company".[9]The definition of "conduit company" that was given by the ECJ falls in two cumulative criteria:

– The activity of the company solely exists of receiving and paying dividends to the beneficial owner or other conduit companies. This can either be a contractual obligation or it can follow from the fact that the company does not have the (economic) right to use and enjoy those dividends "in substance", e.g. dividends received are in practice (almost) fully distributed onwards within a short period of time. The authors call this the "conduit test".[10]

– The absence of actual economic activity must, in the light of the specific features of the economic activity in question, be examined 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. The authors call this the "substance test".[11]

2.3.2. Payment of tax on the dividends is avoided

Even when the tax authorities are able to demonstrate that there is a conduit company in the structure, the benefits of the Parent-Subsidiary Directive (2011/96) are only to be denied if tax is being avoided. This is a very straightforward test. Under this test, it must be examined what the tax due would have been if the dividends were paid directly to the beneficial owner as if the conduit company had not been interposed. If the tax burden is higher in a direct situation, tax is deemed to be avoided. The authors call this the "avoidance test".

In addition to that, the ECJ ruled that if the beneficial owner is residing in a country with whom the source state has concluded a tax treaty, abuse still cannot be ruled out. However, if the dividends were exempt and if they were paid directly (e.g. following a tax treaty or another exemption), it remains possible that the structure is not abusive. The authors' view is that if the conduit company receiving the dividend is not in a better fiscal position than the (actual) beneficial owner of the dividend, a structure can never be abusive because the definition of abuse in the context of direct taxation requires a tax advantage (*see* section 2.3.).

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8. UK: ECJ, 12 Sept. 2006, Case C-196/04 , *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* , Case Law IBFD.
9. L.C. van Hulten & J.J.A.M. Korving, *Svig og misbrug: de Deense antimisbruikzaken* , WFR 2019/129.
10. Consideration 104 and especially Consideration 105.
11. Consideration 104.

2.4. Summary of the ruling in the Danish cases

In the Danish cases the ECJ ruled that article 1(2) of the Parent-Subsidiary Directive (2011/96) does not prevent Member States to apply anti-abuse provisions denying the benefits of the Parent-Subsidiary Directive (2011/96). Even if there is no domestic anti-abuse provision, Member States can still deny the benefits of the Parent-Subsidiary Directive (2011/96) on the basis of the general legal principle that EU law cannot be relied on for abusive or fraudulent ends.

The ECJ further ruled that in the context of the Parent-Subsidiary Directive (2011/96) abuse of law is in place if:

(1) a conduit company is interposed in the structure of the group between the company that pays dividends and the company in the group that is their beneficial owner; and

(2) payment of tax on these dividends is avoided.

With regard to (1), the definition of a conduit company falls in two criteria:

– the legal or actual activity of the company solely exists of receiving and paying dividends to the beneficial owner or other conduit companies (conduit test); and

– the company has no (other) actual economic activities, i.e. local management, cost structure, employees, premises and equipment must be examined (substance test).[12]

With regard to (2), if the tax burden was higher in a situation where the conduit company had not been interposed, tax is being avoided (avoidance test).

3. Deister Holding

In literature, it has been implied that the ECJ's ruling in *Deister Holding* [13]is obsolete since the ruling in the Danish cases.[14]In *Deister Holding* , the German tax authorities denied the benefits of the Parent-Subsidiary Directive (2011/96) on the basis of their domestic anti-abuse provision. The German domestic anti-abuse provision contained a number of substance criteria for the shareholder. If the criteria were met, the exemption was applicable. If the criteria were not met, the structure was considered abusive. The ECJ ruled in this case that:

> As regards measures for the prevention of fraud and abuse within the meaning of Article 1(2) of the Parent-Subsidiary Directive, it should be noted that, since that provision provides for an exception to the general rules laid down by the directive, namely the common tax rules applicable to parent companies and subsidiaries coming within the scope of the directive, it must be subject to strict interpretation.[15]
>
> In order to determine whether an operation pursues an objective of fraud and abuse, the competent national authorities may not confine themselves to applying predetermined general criteria, but must carry out an individual examination of the whole operation at issue. The imposition of a general tax measure automatically excluding certain categories of taxable person from the tax advantage, without the tax authorities being required to provide even prima facie evidence of fraud and abuse, would go further than is necessary for preventing fraud and abuse.[16]

Now that the ECJ did not refer to the *Deister Holding* case in its rulings in the Danish cases, it has been argued that the ECJ came back from its decision in the *Deister Holding* case.[17]However, the authors do not agree with this view for three reasons.

3.1. Legal certainty

First of all, and this may not be the strongest argument, the ECJ generally does not come back from a ruling within one year. The legal certainty would be compromised if the ECJ leaves its position in such a short period.

3.2. Facts and circumstances reviewed in the Danish case

Secondly, the Danish tax authorities and the Danish Ministry of Finance carried out a very thorough investigation to the facts and circumstances in the Danish cases and based their position clearly not on a general presumption of fraud and abuse, which was the case in *Deister Holding* . The authors argue that today the ECJ would still not accept such general rule. This also explains why the ECJ also required, in the Danish cases, an examination of all relevant factors (which has been referred to above as the substance test). In the *Deister Holding* case, no such examination on all relevant facts and circumstances was brought to the ECJ as evidence. Instead, only the absence of the general requirements was mentioned.

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12. Id.
13. *Deister Holding* (C-504/16).
14. Van Hulten & Korving, *supra* n. 9 .
15. Consideration 59.
16. Consideration 62.
17. Van Hulten & Korving, *supra* n. 9 .

3.3. Abuse of law requires a strict interpretation

Thirdly, also from the Danish cases, it can be derived that the ECJ requires a strict interpretation of the abuse of law concept. This argument is further developed in section 4.

4. Interpretation of Abuse

As mentioned in section 3. , the authors argue that the abuse of law concept is still subject to a strict interpretation and did not significantly change since the ruling in the Danish cases.

4.1. *Cadbury Schweppe*s case

A well-known case in respect of abuse of law in the area of direct taxation is the *Cadbury Schweppes* case.[18]In this case, the ECJ decided that a restriction of the freedom of establishment can only be justified on the ground of prevention of abusive practices when the structure involves the creation of a *wholly artificial arrangement* that does not reflect economic reality, with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory.

Also, in the case the ECJ explained that in order to constitute a wholly artificial arrangement, there must be:

– a subjective element, consisting of the intention to obtain a tax advantage; and

– objective circumstances reflecting economic reality.

In this case, it concerned UK CFC legislation, meaning that the objective circumstances must be found in the incorporation and establishment of a subsidiary in another country for other than tax reasons. The ECJ ruled that these findings must be based on objective factors and, in particular, on the extent to which the CFC physically exists in terms of premises, staff and equipment. If these findings do not result in the recognition of a genuine economic activity, the structure can be considered abusive.

4.2. Back to the Danish cases

In the Danish cases, the recipient of the dividends had besides receiving and paying dividends no other economic activity, no local directors, no personnel, no premises and equipment and no local management. There was very little time between their receiving the dividends and paying them onwards, and the recipient earned only just enough from the spread between the ingoing and outgoing dividends to finance the costs related to the holding activities. In light of these facts, the ECJ ruled that these 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. The authors argue that this conclusion is exactly in line with the abuse of law concept that was already defined by the ECJ back in 2006 in the *Cadbury Schweppes* case and, therefore, still subject to a restrictive interpretation. The authors argue that this would mean that even very little economic activity would be sufficient proof that there is no wholly artificial arrangement or not a conduit company under the Parent-Subsidiary Directive (2011/96). In other words, as the ECJ stated, there can be abuse only when the recipient's "sole activity is the receipt of dividends and their transmission to the beneficial owner or to other conduit companies".[19]

The most important difference between the *Cadbury Schweppes* case and the Danish cases is that the *Cadbury Schweppes* case concerned a constraint of the freedom of establishment as laid down in the Treaty on the Function of the European Union (TFEU), also known as primary EU law. While the Danish cases concern the refusal of the application of a European Directive, which must first be implemented into domestic legislation of an EU Member State before entering into force. It is therefore that the taxpayers complained in the Danish cases that Denmark did not implement the abuse provision that is laid down in the Parent-Subsidiary Directive (2011/96). However, as the ECJ ruled (*see* section 2.1.), no such implementation is required, since there is a general concept of abuse of law under EU law. Also, this part of the ruling may not come as a surprise, since the ECJ already ruled in the *Fini H* case in 2005 that no domestic abuse provision is required to deny the benefits of a directive in abusive or fraudulent situations.[20]

5. Conclusion

In the Danish cases, the ECJ further worked out the abuse of law concept in relation to direct taxation under a European directive. The ECJ ruled that these benefits must be denied if a conduit company is interposed in a structure to enjoy the benefits of the directive by reducing tax that would have been due without the interposition of a conduit company. A conduit company is a company that has no other economic activities than receiving and paying dividends. The authors conclude that the ruling is in line with previous case law. As such, tax authorities can only deny the benefits of the Parent-Subsidiary Directive (2011/96) when having reviewed all relevant factors and if there is a clear abusive situation.

18. *Cadbury Schweppes* (C-196/04).
19. Consideration 104.
20. DK: ECJ, 3 Mar. 2005, Case C-32/03 , *I/S Fini H v. Skatteministeriet* , Case Law IBFD.