Analysis

The Danish conduit cases: a landmark ruling on withholding tax and abuse of rights

Speed read

Private equity funds have made extensive use of European holding and finance companies in acquisition structuring. In the Danish conduit cases, the CJEU has found that the establishment of holding companies in European jurisdictions can amount to an abuse of rights in some circumstances. Abusive holding companies will not qualify for withholding tax exemption under the Parent-Subsidiary Directive or the Interest and Royalties Directive, even where exemption would otherwise apply under domestic rules.

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In an alarming development for some private equity funds, the Court of Justice of the European Union (the CJEU) has issued two judgments in the combined *N Luxembourg 1* (Case C-115/16), *X Denmark* (Case C-118/16), *Danmark I* (Case C-119/16) and *Z Denmark* (Case C-299/16) *v Skatteministeriet* and *T Danmark and Y Denmark Aps* (C-116/16 and C-117/16) (I'll call them the Danish conduit cases) which implies support for, or at the very least fails to quash, the proposition that the establishment of holding companies in Luxembourg and other European jurisdictions can be abusive and may not qualify for exemption from withholding tax under the Interest and Royalties Directive (2003/49/EC) or the Parent-Subsidiary Directive (90/435/EC, now replaced by 2011/96/EU), even where the holding companies are established on a commercial basis. This follows a recent decision of the Italian Supreme Court (No. 32255), which also denied the withholding tax exemption under the Parent-Subsidiary Directive, though for different reasons.

The CJEU judgment does not actually decide the cases, which will now return to the Danish courts to interpret and apply to the facts in light of the typically Delphic pronouncements of the CJEU.

There are slight differences between the fact patterns in the various cases, which will also be relevant to multinational companies and others that have made use of intermediate holding companies. The first case (C-115 and C-116) is relatively typical and will be a familiar scenario to those involved in private equity transactions. A consortium of private equity funds with a typically diverse pool of investors acquired a Danish company (a service provider). In order to make the acquisition, the funds set up a string of Luxembourg and Danish companies. The acquisition was partially financed by a loan from the funds to the Danish acquisition company. When Denmark introduced withholding tax on interest, the group reorganised so that the debt was acquired by one of the upper tier Luxembourg companies, which was itself financed by back to back loans leading back to the funds. The Danish acquisition company paid interest on the debt without withholding tax in reliance on the Interest and Royalties Directive. Following a further reorganisation, the Danish acquisition company paid dividends to another of the upper tier Luxembourg companies, this time relying on the Parent-Subsidiary Directive to escape withholding tax.

SKAT, the litigious Danish tax authority, now asserts that withholding tax should have been paid and is seeking to recover it from the Danish acquisition company (or its successor).

Private equity holding companies

The question of the entitlement of private equity holding companies to treaty benefits is extremely topical in light of BEPS action 6, leading to the ongoing introduction of principal purpose tests (PPT) into a number of double tax treaties and the inclusion of new examples on this question in the commentary to the OECD model tax convention (see our article 'Tax issues on private equity transactions' (Brenda Coleman, Andrew Howard & Leo Arnaboldi III), *Tax Journal*, 7 November 2018). This judgment serves as a reminder that, at least in the eyes of several tax authorities, similar questions already arise under existing law, whether as a matter of domestic law or as a matter of interpretation of double tax treaties or EU Directives.

Before going on to consider the CJEU judgment, it is worth looking at the question of intermediate holding companies from the perspective of a private equity fund. A typical fund will have a wide range of investors; many will be established in jurisdictions with a good double tax treaty network, such as the US, and/ or will be generally tax exempt, such as large pension funds or sovereign wealth funds. The aim of private equity structuring is to avoid the investors being subject to an increased level of taxation compared to direct investment. Unlike a large corporation, the fund will not have a natural home jurisdiction. The manager effectively has a free choice when it comes to determining which jurisdiction to establish the fund vehicle (commonly a tax transparent partnership) and any holding companies in. Both investors and financiers are likely to require that the fund makes its investments by establishing at least one holding company. Notwithstanding the impracticality of subjecting its investors to having to suffer withholding or claim exemption from withholding, it is not in any case practicable for a fund to simply invest directly into a target company.

The fund then faces the question as to where to establish the holding company. A number of European jurisdictions, notably Luxembourg, but including Denmark at one time, as well as the UK, have explicitly developed tax regimes which are favourable for holding companies. While tax will be a factor there are multiple other factors. Funds are likely to favour jurisdictions where they have a presence, and many funds have developed a presence in Luxembourg over time. It is common for such funds to make investments through Luxembourg holding companies even where there is no tax benefit (and often a tax cost) in doing so and some funds will structure all their investments through a master

holding company there.

Private equity funds have traditionally provided a significant portion of the capital for their investments in the form of debt. In many jurisdictions, within the limits permitted by transfer pricing, the interest on such debt would have been deductible against the business profits of the target. BEPS developments have now made it increasingly difficult to achieve deductibility for shareholder debt. Nonetheless, many structures still use shareholder debt due to commercial drivers such as the ease of repatriating funds by repayment of debt, and the priority afforded to debt claims in an insolvency. As a result, many funds have also established platforms in particular jurisdictions which they use to establish finance companies.

Here, too, Luxembourg is a favourite jurisdiction: access to treaties and EU directives is undoubtedly a factor in that success. Such a finance company will typically have premises, and suitably qualified directors/ employees. It can be expected to make a turn which is more than sufficient to cover its costs. However, it should also be noted, as it was by Advocate General Kokott (the AG) in one of her opinions on the Danish conduit cases, that group finance companies, like holding companies, are not labour intensive: there is simply not very much to do during the life of a performing transaction.

Stepping back, though, there is little doubt that the use of Luxembourg and other holding companies produces a better tax outcome than direct investment out of the fund, both in light of the reduced admin, but also because while a significant majority of investors may otherwise be entitled to exemption from withholding taxes, this is unlikely to be 100%.

There is a question for the jurisdictions imposing the withholding taxes too. Is it a sensible exercise of their taxing powers to impose a gross tax, often at rates in the region of 30%, on foreign investment, bearing in mind the significant deterrent effect that is likely to have on such investment?

The OECD, beneficial ownership and conduit companies

The OECD has grappled with the question of treaty entitlement for holding companies for some time. It has been fairly clear since 2003 that naked treaty shopping – where a company in jurisdiction A, which doesn't have a treaty with jurisdiction B, simply interposes a conduit SPV in jurisdiction C, which does have an appropriate treaty – will not be effective. In that case, the conduit will not be the beneficial owner of the interest and so will not qualify for reduced rates of withholding. However, it is also fairly clear (on my reading at least) that this is only intended to catch the most egregious situations. Beyond that it is a question for the source jurisdictions, to whom it is open to address a wider range of situations through domestic or treaty based anti-avoidance provisions, on my reading of the OECD commentary to the model double tax agreement.

The EU appeared to take a similar approach to the Interest and Royalties Directive and the Parent-Subsidiary Directive, both of which made it clear that their terms should not 'preclude' member states from combatting fraud or abuse. On a plain reading, this appears to allow the member states' own anti-avoidance rules to override the directives but does not introduce a free-standing anti-avoidance rule into the directives (though such a rule has been added to the Parent-Subsidiary Directive in 2015).

Denmark challenges both of these propositions, it apparently being common ground that Denmark's domestic anti-avoidance rules do not catch the situations it wishes to contest.

Issues addressed by the CJEU in the Danish conduit cases

The key questions addressed by the CJEU are (in summary):

1. Was the finance company the beneficial owner of the interest for the purposes of the Interest and Royalties Directive (the equivalent question didn't arise under the Parent-Subsidiary Directive which didn't include a concept of beneficial ownership)?
2. If the formal conditions for the directives (including beneficial ownership) were fulfilled, should the benefit of the directives nonetheless be denied to the finance/ holding companies on the basis of abuse of rights?

The AG had addressed these questions and found (in summary):

1. Unless the Danish courts were able to discern something unusual in the fact pattern, the finance company was the beneficial owner of the interest; and
2. There is no free-standing concept of abuse of rights in direct tax matters (unlike VAT); the question could only arise under implementing legislation or caselaw.

> The abuse of rights finding appears to be fairly ground breaking, as its application in tax matters had previously been limited to VAT cases

The CJEU had no such difficulties:

1. While the CJEU rather ducked this question, through references to 'economic reality', the CJEU left plenty of scope for a national court to decide that a chain of back to back loans could be looked through for the purposes of determining the beneficial owner; and
2. This type of arrangement may well be an abuse of rights.

The abuse of rights finding appears to be fairly ground breaking, as its application in tax matters had previously been limited to VAT cases.

Elements of abuse of rights

The constituent elements of an abuse of rights are first, viewed objectively, whether the purpose of the relevant rules has been achieved and second, whether there is a subjective intention to obtain an advantage from the relevant rules by artificially creating the conditions laid down for obtaining it. It is not limited to 'wholly artificial arrangements which do not reflect economic reality', a phrase which may resonate in the memory of UK readers following the *Cadbury Schweppes* case (C-196/04).

In terms of the purpose of the directives, the CJEU took a fairly narrow view that they were aimed at encouraging the single market by removing double layers of taxation on transactions within that market. Entities in third countries, even those in jurisdictions with zero rate treaties with the originating jurisdiction, were not intended to benefit. Additionally, 'the right of taxpayers to take advantage of [tax] competition engaged in by the Member States … cannot be raised against the application of the general principle that abusive practices are prohibited.'

Indicia of abuse of rights in this context are:

1. The interest or dividend is passed on soon after its receipt to entities which do not qualify for the benefits of the directives (even if the payer retains an 'insignificant taxable profit', and whether or not this is

actually required pursuant to a contractual obligation);
2. Receiving the interest/ dividend is the sole activity of the immediate recipient;
3. The closeness in time between the legislation imposing the new withholding tax and the reorganization intended to escape it; and
4. Whether the ultimate recipients of the interest or dividend are treaty qualified is irrelevant (though the CJEU is not entirely consistent on this point).

It is at least clear from this that there is a line beyond which transactions will be safe. However, it is also clear that it is not only transactions which are devoid of non-tax commerciality (such as the conduit transaction I described above) that can be abusive. What is not at all clear is where that line falls. There is a brief nod to substance: 'the management of the company … its balance sheet … staff … premises and equipment.' It can also be argued based on the above, that the key fact here is that the taxpayers had to reorganise from an existing structure as a result of the introduction of withholding tax, and that had the structure been set up from the outset, there would have been no question of abuse, though I doubt that Germany and Italy, both of which submitted observations on the case, will read it that way.

Uncertainty

Rather frustratingly, repeated references included in the AG's opinions to legal certainty are notably missing. As with interpretation of the new PPT, it largely seems to be left to local tax authorities and courts as to how aggressive they choose to be in pursuing withholding tax.

This is a very difficult position for private equity funds. If a withholding tax is clearly payable, it can be factored into the modelling of a transaction and the decision as to whether to invest and how much to pay. Under current levels of uncertainty, it is very difficult to make informed investment decisions.

The position is exacerbated where tax authorities choose to pursue historic transactions. The gross proceeds will already have been distributed to investors and it is likely to prove very difficult to recover those amounts, even if the documents provide a clear path for doing that. The company responsible for the withholding may also have changed hands, with the costs of litigation and any final tax cost falling on the new owners.

Compatibility of withholding tax with the fundamental freedoms

The judgment provides an interesting reminder that withholding tax is a very blunt tool. It is imposed on gross payments and often at different rates to corporate income tax imposed on local recipients. The judgment reminds us that, following the *Brisal* case (C-18/15) a couple of years ago, these features are themselves incompatible with the free movement of capital: withholding tax should not result in non-residents bearing an increased tax burden when compared to resident recipients. However, there is a significant sting in the tail here, as participants in an abusive transaction are unable to avail themselves of any benefits under EU law. The CJEU appear to take some delight in reminding the national court that if the withholding tax is struck down on the basis of the beneficial ownership argument, these restrictions on the ability to recover withholding tax will be relevant whereas if the same transaction fails on the basis of abuse of rights, there will be no such restrictions.

How can private equity funds react?

So, what can private equity funds do? As an initial step, it is worth considering very carefully whether payments that could attract withholding tax need to be made or whether there are alternatives. For example, on an exit, there is likely to be a strong preference for sellers to sell out directly from under the fund, rather than lower down the structure if that would mean that proceeds would need to be returned to investors by way of dividend. Equally, if shareholder debt does not give rise to tax deductions, should it be retained in the structure, particularly if it results in payment of interest subject to withholding? If such payments are desirable, is better protection available under a double tax agreement than under EU Directives or are additional or alternative exemptions available (for example the quoted Eurobond exemption in the UK; this judgment is likely to have a very limited impact for UK acquisition structures); and what is the up to date local advice on the relevant tax authority's approach (recognizing always that this can change with hindsight, as has been suggested was the case in Denmark)?

Where it is necessary to rely on the treaty or a directive, is it advisable to seek a ruling in advance? Is it even worth considering an escrow arrangement, where the amount potentially subject to withholding is retained in the company for some period? In any case, it will be worth focusing on substance in the holding company, both as a matter of fact, and as a matter of record. Fine details such as the phone bill for the relevant companies are noted within the judgment.

Many funds are also seeking to address the possibility of increased levels of withholding tax in future in fund documents, typically by including these in the amounts which will be deemed distributed to investors (which can have the controversial effect of the withholding tax counting towards carry calculations), and also making sure that managers and related entities are able to recover from investors in the event of a withholding tax challenge once money has been distributed to investors. In the event of a challenge, difficult questions arise as to whether it is possible/ desirable to rely on limited liability, and whether other indemnity rights or insurance come into play.

Sunny places for shady people...

Perhaps though, private equity funds should be grateful that the CJEU did not follow the AG in one respect. The AG noted that the private equity funds had made use of transparent entities registered in 'small islands such as the Cayman Islands, Jersey or Bermuda, which are renowned for refusing to cooperate with other tax authorities.' The AG extrapolated from this that the structure may be 'designed to take advantage of a lack of information exchange between the states involved in order to prevent the effective taxation of income recipients.' To anyone involved in private equity structuring or familiar with the strict approach taken in the Cayman Islands (for example) to CRS information, this is likely to look like a fairly wild suggestion, and I'm not sure it would be paranoid to discern a tone of mistrust of private equity in both the AG's opinions and, to a lesser extent, the CJEU ruling. ■

- ▶ CJEU ruling on the Parent-Subsidiary Directive and abuse of law (Ashley Greenbank, 14.3.19)
- ▶ Cases: *N Luxembourg 1, X Denmark, C Danmark I and Z Denmark v Skatteministeriet* (7.3.19)
- ▶ Tax issues on private equity transactions (Brenda Coleman, Andrew Howard & Leo Arnaboldi III, 7.11.18)